Supreme Court, U.S.
FILED
95 1538 MAR 25 1996
OFFICE OF THE CLERK

No.

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1995

ROSCOE C. WEBB, JR.,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

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136 pp

QUESTIONS PRESENTED

1. Does Section 7121(b) of the Internal Revenue Code (26 U.S.C.), which provides that, "in any suit, action or proceeding," closing agreements "shall not be annulled, modified, set aside, or disregarded," deny the Tax Court jurisdiction to enter a decision which in fact disregards and annuls such an agreement?

2. How are two inconsistent resolutions of an income tax dispute to be resolved if both are "final" under the Internal Revenue Code (26 U.S.C.) — one under Section 7121(b) and the other under Section 7481?

LIST OF PARTIES

The parties to the proceedings below were petitioner Roscoe C. Webb, Jr. and the United States (Internal Revenue Service).

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PETITION FOR WRIT OF CERTIORARI

The petitioner Roscoe C. Webb, Jr., respectfully prays that a writ of certiorari issue to review the order and opinion of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled proceeding on October 12, 1995.

OPINIONS AND ORDERS BELOW

The unpublished Order of the Court of Appeals for the Ninth Circuit denying the Petition for Rehearing in this case is reprinted in the appendix hereto at 101a. The Memorandum Opinion of the Court of Appeals for the Ninth Circuit, unofficially published at 95-2 U.S.T.C. (CCH) ¶ 50,584, 76 A.F.T.R.2d (P-H) 6897, is reprinted in the appendix hereto at p. 1a.

The Order of the United States Tax Court denying petitioner's Motion to Vacate Decision is reprinted in the appendix at p. 5a. The Tax Court's Memorandum Opinion,

T.C. Memo 1994-549, is reprinted in the appendix hereto at p. 6a.

The unreported Memorandum Order of the Court of Appeals for the Ninth Circuit remanding the case and requiring the Tax Court to file Webb's Motion to Vacate is reprinted in the appendix hereto at p. 29a.

The Tax Court's Order denying Webb leave to file his Motion to Vacate Decision is reprinted in the appendix at p. 31a.

The original unpublished Decision of the Tax Court is reprinted in the appendix hereto at p. 33a. The original Memorandum Opinion of the United States Tax Court, T.C. Memo 1990-556, is reprinted in the appendix hereto at p. 35a.

JURISDICTION

Jurisdiction was conferred on the Tax Court by sections 7442 and 6214(a) of the Internal Revenue Code, as amended (26 U.S.C.) (hereinafter sometimes referred to as the "Internal Revenue Code" or "I.R.C."). Jurisdiction of the Tax Court initially resulted from the timely filing of a petition with the Tax Court in response to an Internal Revenue Service notice of deficiency. The jurisdiction of the Tax Court to enter its original decision in conflict with I.R.C. § 7121(b) is the subject of this petition.

Jurisdiction of Webb's appeal to the Court of Appeals for the Ninth Circuit was conferred by section 7482 of the Internal Revenue Code (26 U.S.C.).

The jurisdiction of this Court to review the judgment of the Ninth Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

26 U.S.C. § 7121. CLOSING AGREEMENTS.

(a) AUTHORIZATION. — The Secretary is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

(b) FINALITY. — If such agreement is approved by the Secretary (within such time as may be stated in such agreement, or later agreed to) such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact —

> (1) the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer, employee, or agent of the United States, and
>
> (2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

STATEMENT OF THE CASE

On February 1, 1985, the IRS mailed a notice to the petitioner-taxpayer, Roscoe Webb ("Webb"), determining a deficiency in his income taxes for 1981. The IRS-determined deficiency resulted from the disallowance of Webb's entire share of a tax loss reported by a partnership known as the Far West Drilling Associates Partnership (the "Partnership").

Webb, a surgeon, had little understanding of the procedures involved in resolving tax disputes. After receiving the notice of deficiency, Webb, a California resident, understood

only that tax matters concerning his interest in the Partnership were being resolved by New York attorneys retained by the Partnership. A petition was timely filed with the Tax Court by said attorneys on May 6, 1985. Webb did not retain the attorneys and did not know what procedures were being implemented to resolve the matter.

On February 3, 1988, the IRS notified Webb by letter that his 1982 tax return had also been selected for disallowance of the Partnership loss. That notice included an offer to settle the Partnership issue for 1982 and all other years. The proposed settlement: (i) allowed Webb a deduction in 1981 (the first year of his investment in the Partnership and the year which was the subject of the then-pending Tax Court proceeding) in an amount equal to 75% of the amount of his actual cash investment; (ii) provided that no penalties otherwise asserted by the IRS would apply to any year with respect to the Partnership issue; (iii) provided that interest on any deficiency would be computed under the increased rate provided for under I.R.C. § 6621(c); and (iv) provided that no deduction for Partnership losses (except the deduction in (i) above) would be allowable in any year.

In April, 1988, Webb accepted the IRS settlement offer by signing and returning the forms provided by the IRS's agent, together with photocopies of Webb's checks substantiating his cash investment in the Partnership.

Pursuant to the settlement reached, Webb and the IRS entered into a formal "Closing Agreement on Final Determination Covering Specific Matters pursuant to I.R.C. § 7121" (the "Closing Agreement"). The Closing Agreement was executed by Webb on May 26, 1988, and by an IRS Section Chief on June 3, 1988. In its most pertinent parts, the Closing Agreement stated:

> "1. The taxpayers are entitled to an ordinary deduction in the amount of $69,930 for the taxable year

ending December 31, 1981, with respect to their investment in the Partnership. Said amount represents 75% of their cash investment in the Partnership.

* * *

"5. The taxpayers are not entitled to any deductions in the taxable year ending December 31, 1981, or in any subsequent year, other than the deductions which are set forth in paragraphs '1' and '2' above.

* * *

"7. No penalty shall be assessed against the Taxpayers for the taxable year ended December 31, 1981 or any subsequent taxable year by reason of the disallowance of any losses claimed as a result of their interest in the Partnership. The increased interest rate pursuant to I.R.C. § 6621(c) shall apply."

Neither the IRS nor Webb brought the Closing Agreement to the attention of the Tax Court. Webb testified in a declaration that at the time he executed the Closing Agreement he did not understand that the New York attorneys had actually commenced a Tax Court proceeding on his behalf. Apparently without cognizance of the Closing Agreement, Webb's Tax Court case was consolidated for trial of the Partnership issue, and proceeded thereto, with eleven other cases. Webb was subpoenaed by IRS attorneys to appear at trial.

Webb was confused by the need to appear since he thought his case had been resolved. When Webb questioned the IRS attorneys, however, he was simply told that he was required to appear in response to the subpoena and he did so.

The Tax Court rendered its Memorandum Opinion on October 25, 1990. T.C. Memo. 1990-556. That opinion: (i) disallowed Webb's entire share of the Partnership loss ($104,033), (ii) found Webb liable for negligence penalties, and (iii) held that the increased interest rate under I.R.C. § 6621(c) applied. The IRS submitted computations to the court based on the Tax Court's Opinion on February 8, 1991, and a Decision was entered on that basis on April 10, 1991.

Assuming that Webb's liability was assessed on or about August 16, 1991, the Decision would result in a liability of $310,238.67, consisting of $69,363.00 in tax, $82,603.99 in negligence penalties and $158,271.68 in interest. The record does not contain evidence of the exact amount Webb would owe under the Closing Agreement, but it can be approximated. Under the Closing Agreement, Webb would be allowed a deduction of $69,930 (compared to zero allowed under the decision); he would owe *no* penalties; and the increased interest rate, although still applicable, would apply to a significantly smaller amount. If one applies the same overall tax rate resulting from the Tax Court Decision to the adjustment under the Closing Agreement, the Closing Agreement deficiency would be $22,738; interest under the I.R.C. § 6621(c) rate to the same August 16, 1991 date would be approximately $55,326, for a total liability of $77,064, instead of the approximately $310,238 liability under the Tax Court Decision.

Webb obtained his own counsel after receiving IRS demands for payment. Webb's new counsel sought to have the Tax Court Decision vacated and a new one, consistent with the Closing Agreement, entered as required by I.R.C. § 7121. On December 27, 1991, he lodged a Motion to Vacate Decision with the Tax Court and filed a Motion for Leave to file it. Webb's motion asserted that the Tax Court lacked jurisdiction to render a decision inconsistent with a

closing agreement under I.R.C. § 7121. The IRS argued both that the Closing Agreement had no jurisdictional impact and that the IRS Section Chief, otherwise authorized to execute closing agreements, had no authority under internal IRS delegation orders to execute a closing agreement if it affected a case pending before the Tax Court. The Tax Court denied Webb leave to file his motion. Webb appealed that Order to the Court of Appeals for the Ninth Circuit on May 11, 1992.

On October 29, 1992, while Webb's appeal was pending, the IRS mailed Webb another notice of deficiency, asserting that Webb was liable for negligence penalties in connection with the disallowance of his share of Partnership losses for the tax year 1984. (Webb had already paid the 1984 tax deficiency resulting from disallowance of the Partnership loss.) In response to the IRS notice regarding 1984, Webb's new counsel filed a petition with the Tax Court alleging that the Commissioner erred in disregarding the Closing Agreement, which precluded application of penalties. The IRS acknowledged the Closing Agreement and conceded that case by stipulated Decision entered January 28, 1993. The Court of Appeals was advised of those events.

On February 14, 1994, the Court of Appeals remanded the case to the Tax Court with instructions to file and hear Webb's motion to vacate, because the motion "sought to vacate [the Tax Court's] original decision for lack of jurisdiction."

On remand, the Tax Court accepted new briefs from the parties but no further evidentiary hearing was held.[1] No

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[1]The only "additional" or "new" evidence was a Stipulation of Facts submitted by the parties to resolve the question of the timeliness of the original petition, and the documents from Tax Court docket no. 24771-92 showing the IRS concession of 1984 penalties based on the Closing Agreement.

evidence was offered by the IRS to support its lawyer's asserted interpretation of ambiguous delegation orders; or to explain why the IRS lawyer conceded the penalty issue in the 1984 case based on the same Closing Agreement; or to explain why the IRS section chief who signed the Closing Agreement did so if he lacked authority, as the IRS argued. The documents revealing the IRS's concession in the 1984 Tax Court case were attached to Webb's Brief on Remand with a request that the Tax Court take judicial notice of their substance.

On October 31, 1994, the Tax Court issued its Memorandum Opinion accepting the arguments of IRS counsel, based solely on an ambiguous delegation order and no additional facts, that the IRS Examination Division Section Chief who signed the Closing Agreement lacked authority. The Tax Court suggested that the IRS concession of the 1984 Tax Court case based on the Closing Agreement was irrelevant, and further held that, in any event, a Closing Agreement cannot restrict jurisdiction of the Tax Court. An order reflecting that Opinion was entered on November 30, 1994.

Webb again timely appealed to the Ninth Circuit.

On October 12, 1995, the Ninth Circuit Court of Appeals filed its Memorandum Opinion affirming the Tax Court. The Court of Appeals assumed the validity of the Closing Agreement, but nevertheless held that Section 7121(b) is not jurisdictional, and that even if the statute *was* jurisdictional, the original Tax Court decision was not void and could not be vacated. Because the Ninth Circuit assumed the validity of the Closing Agreement, there is no issue concerning its validity for purposes of this petition.

On October 26, 1995, Webb timely filed a Petition for Rehearing.

The Petition for Rehearing was denied by the Court of Appeals on January 5, 1996.

REASONS FOR GRANTING THE WRIT

I.

THE NINTH CIRCUIT DECISION CONFLICTS WITH DECISIONS OF THE PRIOR COURT OF CLAIMS. THE STATUTORY PROHIBITION AGAINST ANNULLING OR SETTING ASIDE CLOSING AGREEMENTS IS JURISDICTIONAL.

This Court has granted *certiorari* where a decision of a court of appeals conflicted with decisions of the former United States Court of Claims. *See, e.g., Rowan Cos. v. United States*, 452 U.S. 247, 250 n. 7 (1981); *United States v. Hopkins*, 427 U.S. 123, 124 (1976); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 4 (1974); *Waterman S.S. Corp. v. United States*, 381 U.S. 252, 258 (1965).

The Ninth Circuit's decision in this case conflicts with the Court of Claims decision in *Bankers' Reserve Life Co. v. United States*, 42 F.2d 313 (Ct. Cl. 1930), *cert. den.*, 282 U.S. 871 (1930), which held that the predecessor of 26 U.S.C. § 7121(b) imposed jurisdictional limitations.

Section 7121(b)[2] provides that a closing agreement entered into by the IRS is *final and conclusive* and, absent fraud, malfeasance or misrepresentation of a material fact,[3] "*shall not* be annulled, modified, set aside, or disregarded" in any suit, action or proceeding. I.R.C. § 7121(b)(2) [*emphasis* added].

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[2]Section references are to the Internal Revenue Code (26 U.S.C.), as amended, unless otherwise indicated.

[3]No fraud, malfeasance or misrepresentation of a material fact is alleged to exist in this case.

In *Bankers' Reserve Life Co. v. United States*, 42 F.2d 313 (Ct. Cl. 1930), *cert. den.*, 282 U.S. 871 (1930), the United States Court of Claims held that it lacked jurisdiction to entertain a refund suit brought to recover taxes paid pursuant to a closing agreement which settled the liability. The taxes were determined to be due pursuant to a revenue statute which was subsequently ruled invalid by this Court in another case. In denying jurisdiction to hear the case, the Court of Claims said:

> "We think it is plain, in view of the agreement entered into between the plaintiff and the commissioner with the approval of the Secretary of the Treasury, that under [the predecessor to section 7121(b)] this court is without jurisdiction to entertain this suit." *Bankers' Reserve Life Co. v. United States*, 42 F.2d at 315.

The Court of Claims relied on the plain language of the statute and found that the very purpose of the suit was to set aside the determination and assessment which had been made pursuant to the closing agreement.

It should be noted that one month after the Court of Claims' decision in *Bankers' Reserve Life Co. v. United States*, the Second Circuit addressed the same issue arising from a district court in *Aetna Life Insurance Co. v. Eaton*, 43 F. 2d 711 (2d Cir. 1930), *cert. den.*, 282 U.S. 887 (1930). There, the district court had, like the Court of Claims, held that § 7121(b)'s predecessor deprived it of jurisdiction to hear a refund suit. The Second Circuit reversed, however, holding that the statutory provision "established a rule of law defining the duty of the court, and did not limit its jurisdiction." *Id* at 714. The Second Circuit noted that:

> "[w]hether the clause had [a jurisdictional effect] is a close question and one which, in *Bankers' Reserve Life*

> *Co. v. United States* [citation omitted], the Court of Claims has answered in the affirmative." *Id.* at 714.

Although the Second Circuit reversed on the jurisdictional issue, it remanded the case to the district court with instructions to dismiss for failure to state a cause of action. Thus, although the Court of Claims and the Second Circuit disagreed on the jurisdictional impact of § 7121(b)'s predecessor, both courts upheld the effect of the closing agreements, thereby preserving the integrity of the statute. Here, however, the rulings of the Tax Court and Ninth Circuit undermine and contradict the clear mandate of § 7121(b).

In reaching its conclusion vis-a-vis district court jurisdiction, the Second Circuit relied on cases addressing the jurisdiction of courts of *general jurisdiction*. The Second Circuit quoted this Court's opinion in *Fauntleroy v. Lum*, 210 U.S. 230, 235 (1908), wherein Justice Holmes wrote:

> "Whether a given statute is intended simply to establish a rule of substantive law, and thus to define the duty of the court, or is meant to limit its power, is a question of construction and common sense. When it affects a *court of general jurisdiction*, and deals with a matter upon which the court must pass, we naturally are slow to read ambiguous words as meaning to leave the judgment open to dispute, or as intended to do more than to fix the rule by which the court should decide." [*emphasis* added].

Mr. Justice Holmes' above-cited comments in *Fauntleroy v. Lum* addressed a state statute providing for the unenforceability of certain futures contracts. It was argued that the statutory language precluding enforcement of such contracts deprived the court of jurisdiction. This Court, with good reason, found the statute substantive, not procedural, in its intent. Clearly, all courts are under a duty to render judgments consistent with the applicable substantive law; but

they do have jurisdiction to be wrong in that regard. Section 7121(b), however, provides for the finality of resolutions reached by certain formal agreements and, by its terms, intends to prohibit further judicial review of matters so resolved.

Further, unlike the courts of general jurisdiction addressed by the Second Circuit in *Aetna* and referred to by this Court in *Fauntleroy v. Lum*, the Tax Court is a court of limited, and strictly construed jurisdiction, specifically confined to the provisions of the Internal Revenue Code and related statutes. I.R.C. § 7442.

I.R.C. § 7442 confers on the Tax Court such jurisdiction as is specifically defined by the Internal Revenue Code or by specified other revenue statutes. The Tax Court's jurisdiction is not unlimited or general in nature. The Tax Court itself has recognized that "its jurisdiction is strictly limited by statute and that it may not enlarge upon that statutory jurisdiction." *Breman v. Commissioner*, 66 T.C. 61, 66 (1976), *Estate of Young v. Commissioner*, 81 T.C. 879, 881 (1983). The Tax Court has further recognized that it may lack jurisdiction to enter a particular order or grant particular relief even when it has general jurisdiction over the case itself. *See, e.g., Pesch v. Commissioner*, 78 T.C. 100, 130-131 (1982) (where the Tax Court acknowledged that it lacked jurisdiction to relieve a spouse from a joint return deficiency resulting from disallowance of a net operating loss carried back from a separate return, because such relief was essentially equitable). *See, also, The LTV Corporation v. Commissioner*, 64 T.C. 589, 597 (1975) (where the Tax Court found a lack of jurisdiction to determine issues for interest computations and beyond the extent necessary to reach a decision that no deficiency was due for the year before the court). It is nothing new to recognize that there are limits to the Tax Court's powers even when the parties and subject matter are properly before it. In the two cited

cases, the Tax Court declined to exceed its jurisdiction and refused to enter the requested orders or grant the requested relief. Those cases were otherwise properly before the court, as was this case below. Had the Tax Court in the above-cited cases exceeded its jurisdictional limitations and granted the unauthorized relief requested, its decisions would likewise have been void and subject to attack.

As a provision providing for finality and limiting what *courts* may do vis-a-vis closing agreements, § 7121(b) is one of the provisions defining the Tax Court's jurisdiction as referred to by section 7442. Thus, the Tax Court was not empowered to disregard, annul or set aside the Closing Agreement between Webb and the IRS.

Contrary to the Court of Claims opinion in *Bankers' Reserve Life*, and unlike the Second Circuit in *Aetna*, which found the jurisdictional issue a "close question," the Ninth Circuit in this case dismissed the jurisdictional issue with nominal comment, simply concluding that "§ 7121(b) is not intended to be jurisdictional in nature...." The Ninth Circuit gave two reasons for its conclusion: (a) the absence of statutory language clearly indicating a jurisdictional directive, and (b) language in the legislative history of the section's predecessor that the section was "aimed at the constant reopening of closed cases." The Ninth Circuit's analysis was flawed and inconsistent with the analysis of other courts.

Relying on the absence of clear jurisdictional language, the Ninth Circuit said:

> "While other statutes that place limits on the Tax Courts' [sic] jurisdiction clearly say so, see *e.g.*, 26 U.S.C. § 6226(f), § 7121(b) is conspicuously silent."

In looking for clear jurisdictional language in § 7121(b), the Court overlooked the fact that tax code sections with origins

predating the 1954 tax code, like section 7121, were *not* all specific as to their jurisdictional significance. Section 6226(f), compared by the Ninth Circuit, was not added to the tax code until 1982, and was an inappropriate reference point. The most obvious example of a section of the tax code which is jurisdictional despite the lack of clear statutory language to that effect is section 6213(a). That section, like § 7121, was incorporated into the Internal Revenue Code of 1954 from prior law. Prior to amendments made in 1988 by the Technical and Miscellaneous Revenue Act ("TAMRA", P.L. 100-647), section 6213(a) provided that a taxpayer "may file a petition with the Tax Court" within (in most cases) 90 days after mailing of a notice of deficiency by the IRS. Notwithstanding that section's silence as to any jurisdictional intent, the courts, including the Ninth Circuit, consistently held that the filing of a petition within the specified period was jurisdictional. *Healy v. Commissioner*, 351 F.2d 602 (9th Cir. 1965), *Jorgensen v. Commissioner*, 246 F.2d 536 (9th Cir. 1957), *DiProspero v. Commissioner*, 176 F.2d 76 (9th Cir. 1949). The 1988 TAMRA amendments granted the Tax Court jurisdiction to enjoin improper IRS assessment and collection action and expressly conditioned that new jurisdiction on a timely filed petition. That section has, however, always been silent as to the jurisdictional necessity of a timely petition in general.

If anything, section 7121(b)(2) is *clearer* than section 6213(a) is in indicating an intent to affect court powers by clearly precluding decisions inconsistent with closing agreements. Thus, although recently added provisions may clearly express their jurisdictional intent, Congress' intent with respect to § 7121 should be viewed in the light of sections of similar "vintage." Neither the Court of Claims in *Bankers' Reserve Life Co.* nor the Second Circuit in *Aetna* was concerned with the statute's lack of clear jurisdictional language. Section 7121's silence as to its jurisdictional nature is entirely consistent with other jurisdictional provi-

sions whose origins predate the 1954 revenue code, and does not militate against a finding of its jurisdictional nature.

The Ninth Circuit's analysis of the legislative history of § 7121(b) was also flawed. The court concluded that the section's legislative history militated against a finding of any jurisdictional effect, saying:

> ". . . Section 606, § 7121(b)'s predecessor, was aimed at discouraging the 'constant reopening of closed cases.' H.R. Rep. No. 2, 70th Cong., 1st Sess. 32 (1928) . . . Limiting the jurisdiction of the Tax Courts [sic] is beyond this purpose."

The Court of Appeal's conclusion, however, begs the jurisdictional question, and is contrary to the plain language of the statute. Under § 7121(b), and consistent with the above-quoted language, Webb's tax dispute should have ended with the Closing Agreement. As a result of error, at least on the part of Webb, it did not, and the Tax Court decided the dispute in a manner inconsistent with the Closing Agreement. The legislative history is entirely consistent with a conclusion that Congress intended the statute to forbid courts from ignoring closing agreements and in no way militates against vacating a court decision inconsistent with such an agreement.

II.

THE NINTH CIRCUIT DECISION BELOW CONFLICTS WITH OTHER COURT DECISIONS HOLDING THAT THE INTERNAL REVENUE CODE DEPRIVES THE TAX COURT OF JURISDICTION TO DISTURB "FINAL" RESOLUTIONS.

The IRS (as a delegate of the Secretary of the Treasury) is authorized to make inquiries, determinations and assessments. Sec. 6201. If, as a result of its inquiries, the IRS determines that a deficiency exists, it is authorized (and in

some circumstances required prior to assessment) to send a notice of deficiency. Sec. 6212. The Tax Court is specifically granted jurisdiction to redetermine the correct amount of a deficiency if a petition is filed with it in response to an IRS notice issued under § 6212. The foregoing is the general procedural framework in which income tax disputes such as Webb's find their way to the Tax Court.

Congress also included two finality provisions to the above tax dispute resolution framework: Section 7481, which dictates when a Tax Court resolution becomes final; and Section 7121, which dictates when a resolution reached by agreement is final.

The Circuit Courts have consistently held that, except in cases where the court lacked jurisdiction or there was fraud on the court, § 7481 deprives the Tax Court of jurisdiction to vacate a decision once it becomes final under the statute. *Lasky v. Commissioner*, 235 F.2d 97 (9th Cir. 1956), *aff'd* 352 U.S. 1027 (1957), *Harbold v. Commissioner*, 51 F.3d 618, 621 (6th Cir. 1995), *Webbe v. Commissioner*, 902 F.2d 688, 688-89 (8th Cir. 1990), *Stickler v. Commissioner*, 464 F.2d 368, 370 (3d Cir. 1972) (per curiam), *Kenner v. Commissioner*, 387 F.2d 689 (7th Cir. 1968); *see also Lentin v. Commissioner*, 243 F.2d 907, 908-09 (7th Cir. 1957). In *Lasky*, the Ninth Circuit reasoned that the Tax Court was essentially an administrative agency without inherent power to vacate its decisions, particularly in light of the revenue code section defining when Tax Court decisions become "final." This Court summarily affirmed *Lasky*, citing *R. Simpson & Co. v. Commissioner*, 321 U.S. 225 (1944) and *Helvering v. Northern Coal Co.*, 293 U.S. 191 (1934). *Lasky v. Commissioner*, 352 U.S. 1027 (1957). In *R. Simpson & Co. v. Commissioner*, this Court held that the "finality" provisions of the predecessor to § 7481 deprived it of jurisdiction to grant a rehearing of its denial of certiorari.

The courts below relied on the foregoing authorities in refusing to vacate the original Tax Court decision. The above-cited cases, however, equally support the conclusion that the Closing Agreement's finality similarly deprived the Tax Court of jurisdiction to enter a decision which undermined that agreement.

There is no dispute that the provisions providing for the finality of tax dispute resolutions in the Tax Court, when effective, deprive that court of jurisdiction to further consider the matter. Section 7121 has received less judicial attention, perhaps because the parties infrequently attempt to avoid closing agreements; but there is no reason for a different conclusion regarding the jurisdictional effect of finality under *that* section.

Section 7121(b) provides for the finality of closing agreements, and further provides that courts *shall not* annul, set aside or disregard them in any action or proceeding; yet that is precisely what the Tax Court did below unless it and the Ninth Circuit are reversed. There is no legitimate basis upon which to conclude that the finality provisions of § 7481 are any more conclusive than the finality provisions of § 7121(b). It makes no sense for the Tax Court to have jurisdiction to ignore and disregard a *final* determination under a closing agreement, contrary to clear statutory language, yet lack jurisdiction to vacate or revise a decision which is "final" under a different revenue code section. The Ninth Circuit failed to reconcile the two finality provisions. The only reconciliation which makes sense in the present context requires the Tax Court decision to be vacated and conformed to the Closing Agreement. The Ninth Circuit erred in not requiring the Tax Court to do so.

III.

THE NINTH CIRCUIT'S HOLDING THAT THE TAX COURT DECISION WOULD NOT BE VOID EVEN IF § 7121 *WAS* JURISDICTIONAL CONFLICTS WITH DECISIONS OF THIS COURT AND WITH THE CIRCUIT COURT'S OWN DECISIONS, INCLUDING ITS PRIOR REMAND IN THIS CASE.

The Court of Appeals concluded that "[e]ven [if] § 7121(b) was jurisdictional, that would still not render the 1991 decision void," citing this Court's decision in *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371 (1940), as support. The Ninth Circuit concluded that the "finality" of the original Tax Court decision bars Webb from challenging Tax Court jurisdiction, even if § 7121(b) is jurisdictional, because the matter could have been raised during the original Tax Court proceeding.

Normally, decisions of the Tax Court become final upon expiration of the time allowed for appeal if no notice of appeal is timely filed. I.R.C. § 7481. Ninety days is allowed for filing a notice of appeal. I.R.C. § 7483. Thus, under "normal" circumstances, the Tax Court's Decision in this case would have become final on July 9, 1991.

The Ninth Circuit has recognized, however, that decisions based upon fraud on the Court or a lack of subject matter jurisdiction *never* become final, and that motions to vacate such decisions may be entertained at *any* time. *See, Abatti v. Commissioner*, 859 F.2d 115 (9th Cir. 1988), and *Billingsley v. Commissioner*, 868 F.2d 1081 (9th Cir. 1989).

In *Billingsley*, the Court of Appeals said:

> "Subject matter jurisdiction is fundamental; '[t]he defense of lack of subject matter jurisdiction cannot be waived, and the court is under a continuing duty to dismiss an action whenever it appears that the court lacks jurisdiction.' " *Billingsley*, 868 F.2d at 1085, cit-

ing *Augustine v. United States*, 704 F.2d 1074, 1077 (9th Cir. 1983).

See also, Abeles v. Commissioner, 90 T.C. 103, 105 (1988) and *Brannon's of Shawnee, Inc. v. Commissioner*, 69 T.C. 999, 1002 (1978).

The Ninth Circuit relied on *Billingsley* below in its original remand requiring the Tax Court to file and hear Webb's motion. If the jurisdictional character of § 7121 made no difference, the remand would have been unnecessary. In ordering the remand, the Ninth Circuit must have recognized that the Tax Court decision was necessarily void if section 7121 imposed jurisdictional limits which were exceeded.

"Jurisdictional limits" are defined as "[t]he constitutional or statutory parameters within which judicial power may be exercised . . ." *See, Black's Law Dictionary* (6th ed. 1990).

"Jurisdiction" includes the authority to issue certain orders and grant certain forms of relief. *Id.* That the concept of jurisdiction includes the power to render particular classes of orders is especially evident in courts of limited jurisdiction, such as the Tax Court. Properly invoking the jurisdiction of a court does not give the court "carte blanche"; its orders must be consistent with its statutory authority. The court's exercise of jurisdiction remains, throughout an action or proceeding, subject to all of the constitutional and statutory limitations constraining it. The Tax Court has previously recognized its jurisdictional restrictions on rendering certain orders. *See, e.g., Pesch v. Commissioner*, 78 T.C. 100, 130-131 (1982), and *The LTV Corporation v. Commissioner*, 64 T.C. 589, 597 (1975). More importantly, this Court has long recognized that a court may not ignore the limitations of its jurisdictional mandate, even after a case is properly before it; and decisions which exceed such limitations are

void and must be vacated. In *U.S. to the use of Wilson v. Walker*, 109 U.S. 258 (1883), this Court considered the effect of an order of the District of Columbia Supreme Court directing a removed administratrix to pay a liquidated sum to a successor administrator. The case had been properly brought before the lower court, but the final order exceeded the court's statutory jurisdiction, as the statute authorized the enforcement of a turnover of *un*liquidated assets only and the case involved a liquidated sum. This Court held that the order was void, saying:

> "Although a court may have jurisdiction over the parties and the subject matter, yet if it makes a decree which is not within the powers granted to it by the law of its organization, its decree is void." 109 U.S. at 266.

Thus, a court is no more empowered to exceed jurisdictional limits imposed by Congress than it is empowered to exercise jurisdiction where none exists at all. If a decision or order exceeds the court's statutory limits of power, that decision or order is void, even if the court has jurisdiction over the parties and the subject matter generally. Under those circumstances, the court is empowered and *obligated* to vacate that decision and conform it to the court's jurisdictional mandate. Here, because the Tax Court's original decision violated a jurisdictional mandate, it was void and did not become final.

The Court of Appeals' reliance on *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371 (1940), ignores the line of cases holding that jurisdictional limits, if not determined in the original proceeding and exceeded, preclude the finality of the court decision. *Chicot County Drainage* cannot stand for the proposition that jurisdictional challenges are barred, even if not raised.

This Court has cited *Chicot County Drainage Dist. v. Baxter State Bank* as standing for the proposition that

subsequent new rules or interpretations of law generally will not be applied to override the finality of pre-existing decisions. *See, e.g., James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529, 541 (1991). There is no issue of retroactivity in this case, or of changes in applicable law, whether statutory or decisional. Thus, the Ninth Circuit's reliance on *Chicot County Drainage* was misplaced.

Chicot County Drainage involved an attack on a final district court judgment because a subsequent decision of this Court held that the statute applied by the district court was unconstitutional. The constitutionality of the statute was not raised in the original proceeding. This Court essentially held that the principal of *res judicata* should prevail over subsequent interpretations of the underlying statute, and that the district court's decision should not be set aside. The case did *not* involve an issue of jurisdiction, despite one litigant's unsuccessful alternative argument that the constitutionality of the applicable statute was tantamount to a jurisdictional issue. *Chicot County Drainage Dist.*, 308 U.S. at 376.

This Court has further held that even if a court's jurisdiction is removed after a case is properly brought before it, a decision which offends a jurisdictional mandate at the time it is entered must be set aside, even if otherwise final. *See, e.g., Hallowell v. Commons*, 239 U.S. 506 (1916).

Chicot County Drainage cannot advance the argument that *res judicata* precludes jurisdictional challenges to an otherwise final decision just because jurisdiction *could* have been raised (unless, of course, the jurisdictional issue *was* raised and decided). Since jurisdiction may be challenged in any action, the Ninth Circuit's analysis would suggest that otherwise final decisions could *never* be attacked for want of jurisdiction; and that conclusion, as pointed out, conflicts with a myriad of decisions.

The mandate of section 7121(b)(2) existed at all times throughout this case. Since the section imposes a jurisdictional restriction, the original Tax Court decision is void. Webb's motion to vacate was therefore erroneously denied by the Tax Court, and that decision was erroneously affirmed by the Ninth Circuit. Thus, the decision below should be reversed.

The Ninth Circuit also suggested that *Jones v. Giles*, 741 F.2d 245 (9th Cir. 1984), supported its conclusion that the Tax Court decision would not be void even if § 7121(b) was jurisdictional. *Jones v. Giles*, however, is entirely consistent with reversal in this case. The district court in *Jones v. Giles* specifically held in its original decision that it had jurisdiction, whereas in this case, no jurisdictional issue was originally considered. On appeal in *Jones v. Giles*, the Court of Appeals cited this Court extensively, saying:

> "Federal courts are courts of limited jurisdiction, whose constitutional or congressional limitations must be neither disregarded nor evaded. *Owen Equip. & Erection Co. v. Kroger*, 437 U.S. 365, 374, 98 S.Ct. 2396, 2403, 57 L.Ed.2d 274 (1978). Absence of subject matter jurisdiction may render a judgment void where a court wrongfully extends its jurisdiction beyond the scope of its authority. *Kansas City Southern Ry. Co. v. Great Lakes Carbon Corp.*, 624 F.2d 822, 825 (CA8 1980) (citing *Stoll v. Gottlieb*, 305 U.S. 165, 171, 59 S.Ct. 134, 137, 83 L.Ed. 104, (1938)), *cert. denied*, 449 U.S. 955, 100 S.Ct. 363, 66 L.Ed.2d 220 (1980). An error in interpreting a statutory grant of jurisdiction is not, however, equivalent to acting with total want of jurisdiction and does not render the judgment a complete nullity. *Id. See Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371, 376-77, 60 S.Ct. 317, 319-320, 84 L.Ed. 329 (1940). A void judgment, as

> opposed to an erroneous one, is legally ineffective from inception. *Id.*"

Jones v. Giles, 741 F.2d at 248. (It should also be noted that, unlike the instant case, the statutory provision addressed in *Jones v. Giles* did not purport to place any limits on court powers.)

It is clear that this Court has consistently recognized that a decision which offends the issuing court's jurisdictional mandate is void, and not merely erroneous. It is equally clear that courts have jurisdiction to determine their jurisdiction, and that an erroneous determination of jurisdiction is not void; such was the substance of *Jones v. Giles*. No jurisdictional holding was incorporated into the original Tax Court decision in this case, however; the Tax Court did not address the Closing Agreement or its jurisdictional effect prior to Webb's motion to vacate. Thus, the current jurisdictional challenge is not precluded by *res judicata*.

For the above reasons, the Court of Appeals' reliance on *Chicot County Drainage Dist.* in holding that the Tax Court decision could not be set aside even if section 7121(b) imposed a jurisdictional limitation is inconsistent with its own prior decisions and with decisions of this Court.

IV.

GUIDANCE IS NECESSARY AS TO HOW A CONFLICT BETWEEN TWO INCONSISTENT "FINAL" RESOLUTIONS OF THE SAME TAX DISPUTE SHOULD BE RESOLVED.

The decisions of the Tax Court and the Ninth Circuit created a statutory anomaly. The Closing Agreement entered into by Webb and the IRS is *final and conclusive* under I.R.C. § 7121. The Tax Court and the Ninth Circuit held below that the Tax Court's Decision is final under I.R.C. § 7481 and cannot be set aside. The substance of the

Closing Agreement and that of the Tax Court's Decision are inconsistent. Thus, the refusal of the courts below to vacate the Decision in this case leaves the parties with an unresolved conflict between two inconsistent and "final" resolutions of the same issue. That conflict ought not be left unresolved.

Aside from the jurisdictional nature of section 7121, the conflict ought to be resolved in favor of upholding the Closing Agreement because section 7121 specifically directs that closing agreements are not to be annulled, set aside or disregarded in any suit, action or proceeding; and that is precisely what the Tax Court's Decision and the Ninth Circuit's affirmance do. The Ninth Circuit cited no authority which would support a conclusion that one finality provision (§ 7481) is jurisdictional and the other (§ 7121(b)) is not.

The purpose of section 7121 is to permit the taxpayer and the Government to reach an agreement which finally and completely resolves a matter and prevents its reopening. *See, Wolverine Petroleum Corp. v. Commissioner*, 75 F.2d 593, 595 (8th Cir. 1934).

The statute excludes mistakes of fact as well as mistakes of law as grounds for annulling a closing agreement. Here, the Closing Agreement was disregarded and the Tax Court entered its Decision without knowledge of the agreement's existence. The Eighth Circuit has said:

> "Full consideration dictates that matters affecting the taxpayer's liability once concluded by a closing agreement should be respected in every particular, and subject to attack only upon the grounds enumerated in the statute . . .
>
> "The policy of establishing the finality and conclusiveness of closing agreements once effected, except upon a showing of fraud or malfeasance or misrepre-

> sentation of a material fact, has proven efficacious in encouraging the compromise of troublesome tax matters. To allow the finality of such agreements to be impeached upon grounds other than those enumerated in [the statute] would tend to diminish the salutary effects of the statute." *Wolverine Petroleum Corp.*, 75 F.2d at 596.

Thus, the parties' failure to apprise the Tax Court of the Closing Agreement is not grounds for annulling or setting aside such agreement, either directly or indirectly.

Finally, allowing a party to avoid the effect of a "final" closing agreement as a result of both parties' failure to bring such agreement to a court's attention would undermine the integrity of the finality provision of section 7121 and waste valuable resources: parties could be encouraged to litigate settled matters in the hope that a better result would be obtained and that the other party would fail to timely assert his/her rights under the closing agreement.

Reversal of the Ninth Circuit and Tax Court decision, and entry of a decision consistent with the Closing Agreement, is the only way to avoid both emasculating section 7121 and a conflict between two inconsistent "final" resolutions of Webb's tax dispute.

V.

JUSTICE AND POLICY CONSIDERATIONS REQUIRE REVERSAL IN THIS CASE.

Arguably, modern dissatisfaction with our tax system has resulted more from perceived IRS abuses and distrust of the manner of administering the system than from the system's substantive provisions. *See, e.g.*, James Bovard, *When the IRS Comes After You*, Reader's Digest, March 1996, at 193. This case is an obvious example. Webb settled his tax dispute by an IRS-required agreement which the statute

made final and conclusive. As a result of mutual error, the Tax Court was not apprised of the agreement, and the IRS achieved a better result at trial. Rather than agreeing to abide by the agreement, the IRS has instead sought to preserve its trial victory and avoid the agreement by clever argument. At stake is whether integrity is to be found in a U.S. citizen's dealing with his or her government. There is little doubt how the courts would have ruled if the tables were turned and it was the IRS seeking to reform a decision erroneously entered in favor of the taxpayer. The result below is not only inconsistent with the law, it is grossly unjust, and should be reversed.

CONCLUSION

For the above-stated reasons, this petition for certiorari should be granted to provide certainty and guidance in making and applying closing agreements, to resolve the conflict regarding the jurisdictional significance of 26 U.S.C. § 7121, and to decide how a conflict over two inconsistent "final" resolutions of the same tax dispute is to be resolved. If the Court agrees that § 7121(b) is jurisdictional and that the original Tax Court decision could have been vacated, the Ninth Circuit decision should be reversed, and the case should be remanded to the Ninth Circuit for a decision confirming the validity of the Closing Agreement and reversing the Tax Court.

Respectfully submitted,

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March 22, 1996

APPENDIX

NOT FOR PUBLICATION

No. 94-70888

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ROSCOE C. WEBB, JR.,
Petitioner-Appellant,

v.

COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Tax Ct. No. 11415-85

MEMORANDUM*

FILED

OCT 12 1995

CATHY A. CATTERSON, Clerk
U.S. Court of Appeals

Appeal from a Decision of the
United States Tax Court

Submitted** September 22, 1995
Pasadena, California

Before: HALL and RYMER, Circuit Judges, and
FITZGERALD, District Judge.***

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

** This panel unanimously agrees that this case is appropriate for submission without oral argument. Fed. R. App. P. 34(a); 9th Cir. R. 34-4.

*** The Honorable James M. Fitzgerald, Senior United States District Judge for the District of Alaska, sitting by designation.

Webb appeals from the tax court's denial of his motion to vacate its 1991 decision assessing a deficiency for the 1981 tax year. Webb argues that the court lacked jurisdiction to assess him because he had already entered into a closing agreement with the IRS in 1988 that determined his liability for 1981. Because § 7121(b) governing closing agreements is not jurisdictional in nature and because Webb did not move to vacate the decision until it was final, we affirm the decision of the tax court denying his motion to vacate.

I.

The jurisdiction of the Tax Court is reviewed de novo. *Billingsley v. CIR*, 868 F.2d 1081, 1084 (9th Cir. 1989). A Tax Court judgment, if not appealed, becomes final ninety days after it is entered. 26 U.S.C. §§ 7481(a)(1), 7483 (1995). In this case, the decision being challenged was entered on April 10, 1991, and became final on July 9, 1991. Webb first moved to vacate on December 9, 1991.

The Tax Court has jurisdiction to vacate a final decision only if (1) the decision of the Court was obtained by fraud on the Court, *Abatti v. C.I.R.*, 859 F.2d 115, 117-18 (9th Cir. 1988), or (2) the Court lacked jurisdiction when the decision was entered, *Abeles v. Commissioner*, 90 T.C. 103, 105 (T.C. 1988).[1]

Once properly approved, a closing agreement is "final and conclusive, and . . . in any suit, action, or proceeding, such agreement . . . shall not be annulled, modified, set aside, or disregarded." 26 U.S.C. § 7121(b). Although disputed, we will assume the validity of the 1988 closing agreement.

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[1] A third exception for mutual mistake is not recognized in the Ninth Circuit. *Lasky v. Commissioner*, 235 F.2d 97 (9th Cir. 1956), *aff'd* 352 U.S. 1027 (1957).

II.

Webb contends that § 7121(b) limits the jurisdiction of the Tax Courts. He argues that when the Tax Court entered a decision assessing him a greater deficiency than that assessed under the 1988 closing agreement, it disregarded that agreement, violated § 7121(b), and thereby acted without jurisdiction. He argues that since the Court acted without jurisdiction, its decision can be vacated despite its finality.

Webb's collateral attack must fail because he cannot sustain his burden of proof as to the invalidity of the 1991 decision. *Abeles*, 90 T.C. at 106.

To begin with, § 7121(b) is not intended to be jurisdictional in nature. Webb correctly points out that the Tax Courts are limited in jurisdiction by statute, *see* 26 U.S.C. § 7442, but he fails to show how § 7121(b) is intended to be such a limit. While other statutes that place limits on the Tax Courts' jurisdiction clearly say so, *see, e.g.*, 26 U.S.C. § 6226(f), § 7121(b) is conspicuously silent.

Furthermore, § 7121(b)'s legislative history harms Webb more than it helps him. Section 606, 7121(b)'s predecessor, was aimed at discouraging the "constant reopening of closed cases." H.R. Rep. No. 2, 70th Cong., 1st Sess. 32 (1928). Congress feared that taxpayers would sign a closing agreement, see advantageous changes in the tax law, and attempt to reopen their cases; it wanted closing agreements to be final and not modifiable so as to prevent this. Limiting the jurisdiction of the Tax Courts is beyond this purpose. It is indeed ironic that the finality of this closing agreement has generated more litigation than it has prevented.

III.

Even were we to accept Webb's contention that § 7121(b) was jurisdictional, that would still not render the

1991 decision void. In *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371 (1940), the Supreme Court held that a bankruptcy decree issued under a statute that was later declared unconstitutional could not be collaterally attacked for lack of jurisdiction when none of the parties directly attacked the statute's constitutionality (or, alternatively, the court's jurisdiction). *Id.*, 308 U.S. at 375-77. The Court held that although decrees issued under these circumstances may be "erroneous, and may, upon a writ of error, or appeal, be reversed for that cause . . . they are not absolute nullities." *Id.* at 376 (internal quotation marks omitted). The Court further noted that this rule also applies when "the boundaries of a valid statute have been transgressed." *Id.* at 377. This Court has adopted this rule. *Jones v. Giles*, 741 F.2d 245, 248 (9th Cir. 1984).

The case at bar is directly analogous. Webb is collaterally attacking the Tax Court's jurisdiction because it transgressed the boundaries of § 7121(b) by entering an order disregarding the 1988 closing agreement. Like the plaintiffs in *Chicot County*, Webb had the chance to challenge directly the court's actions but waited until five months after the decision was final to raise his objection. Webb's claim must therefore fail.

IV.

Because the court's original decision is not void, we need not reach Webb's other arguments. The Tax Court decision is therefore AFFIRMED.

Docket No. 11415-85

UNITED STATES TAX COURT
Washington, D.C. 20217

ROSCOE C. WEBB, JR.
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ORDER

Pursuant to the Court's Memorandum Opinion (T.C. Memo. 1994-549) filed October 31, 1994, it is

ORDERED: That petitioner's Motion to Vacate Decision filed March 17, 1994, is hereby denied.

/s/ HOWARD A. DAWSON, JR.
Howard A. Dawson, Jr.
Judge.

Dated: Washington, D.C.
November 29, 1994

T.C. Memo 1994-549

UNITED STATES TAX COURT

ROSCOE C. WEBB, JR., *Petitioner* v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Docket No. 11415-85 Filed October 31, 1994.

Mark Bernsley, for petitioner.
Alan Kline and *Paulette Segal* for respondent.

MEMORANDUM OPINION

DAWSON, Judge: This case is presently before us on petitioner's motion to vacate the decision entered in this case.

I. *General Background*

In *Webb v. Commissioner*, T.C. Memo. 1990-556, we sustained respondent's disallowance of petitioner's claimed deductions for distributive losses resulting from his investment in Far West Drilling Associates (FWDA), which was one of the six limited partnerships that composed the Petro-Tech National Litigation Project.[1] We also sustained respondent's additions to tax. On April 10, 1991, we entered a decision in this case. Because no appeal was taken within 90 days, the decision became final on July 9, 1991. Secs. 7481, 7483.[2]

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[1] Twelve docketed cases from the project, two from each partnership, were consolidated under the caption *Roscoe C. Webb, Jr., et al. v. Commissioner*, docket No. 11415-85. The *Webb* case was subsequently severed from the consolidation after the opinion was filed.

[2] All section references are to the Internal Revenue Code. Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

On December 27, 1991, petitioner filed an untimely motion for leave to file a motion to vacate the decision.[3] On February 3, 1992, respondent filed an objection to this motion. On February 27, 1992, petitioner filed a reply to respondent's objection. On March 17, 1992, we denied petitioner's motion for leave to file the motion to vacate on the ground that there was no factual or legal basis for vacating and setting aside the April 10, 1991, final decision of this Court.

On May 11, 1992, petitioner appealed our denial of his motion for leave to file the motion to vacate the decision. On February 14, 1994, the United States Court of Appeals for the Ninth Circuit filed a Memorandum and entered a Judgment, remanding this case with instructions to grant leave for petitioner to file his motion to vacate our April 10, 1991, decision. The Memorandum of the Court of Appeals stated that petitioner's motion seeks to vacate this Court's decision for lack of jurisdiction, citing *Billingsley v. Commissioner*, 868 F.2d 1081, 1085 (9th Cir. 1989).

On March 17, 1994, in compliance with the mandate of the Court of Appeals, this Court by Order granted petitioner's motion for leave to file motion to vacate decision out of time, and directed the Clerk of the Court to file the motion to vacate decision. On March 29, 1994, petitioner filed a Brief on Remand in support of his motion to vacate the decision. On July 1, 1994, respondent filed a Response to Petitioner's Brief on Remand.

After a July 27, 1994, telephone conference with counsel for the parties, this Court reviewed its legal file and discovered what appeared to be an untimely petition filed in this

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[3]On the same date that petitioner's motion to vacate decision was lodged, Mark Bernsley (Mr. Bernsley) entered his appearance in this matter on petitioner's behalf.

case.[4] Thus, on August 1, 1994, we issued an Order to Show Cause why this case should not be dismissed for lack of jurisdiction and to show cause why the decision entered on April 10, 1991, should not be vacated. On August 8, 1994, the Clerk of the Court was ordered to provide the parties with a copy of the face of the envelope which contained the petition. The Court instructed the parties to produce evidence that the petition was timely filed. On August 30, 1994, Mr. Bernsley (counsel for petitioner) filed a declaration along with a photocopy of a photocopy of the receipt for certified mail, which matches the certified mail number on the envelope that contained the petition. The date stamped on the certified receipt is 1, and the year is 1985. The month is illegible. Nevertheless, on September 6, 1994, the parties filed a Supplemental Stipulation of Facts, wherein they agreed that petitioner timely mailed the petition in this case on May 1, 1985.

Petitioner's motion to vacate the decision raises two issues: (1) Whether respondent's agents possessed delegated authority to enter into the closing agreement with respect to a tax year (1981) that was at issue in an already-docketed Tax Court case; and (2) if the closing agreement is valid, whether section 7121(b) permits the parties in a docketed Tax Court case to limit the Court's jurisdiction by way of a closing agreement that was not specially pleaded as

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[4]Respondent mailed a notice of deficiency for the year 1981 to petitioner at his last known address in Santa Monica, California. The notice of deficiency is dated February 1, 1985, and was apparently mailed on the day that it was dated.

The petition to this Court is dated April 30, 1985, and was mailed to the Court in an envelope that does not bear a U.S. Postal Service postmark. The envelope bears a private postage meter stamp that reads "New York, Mar-1'85", and Certified Mail sticker P449156817, with "Return Receipt Requested" stamped above it. The petition was received by the Court at 9:15 a.m. on Monday, May 6, 1985, which was the 95th day after the notice of deficiency was mailed.

an avoidance or affirmative matter pursuant to Rule 39 prior to the Court's trial, opinion, and decision.

II. *The Notice, Petition, and Closing Agreement*

On February 1, 1985, respondent timely mailed a notice of deficiency to petitioner and Lydia M. Webb (Mrs. Webb).[5] The notice disallowed the $104,033 in losses reflected on petitioner and Mrs. Webb's joint 1981 Federal income tax return, which related to their investment in FWDA. The petition in this case was filed on May 6, 1985. It was executed by Carl M. Kuntz (Mr. Kuntz), as attorney for petitioner. The answer was filed on June 17, 1985.

On April 1, 1987, the parties executed and filed a stipulation of settled issues, which resolved all the issues in petitioner's case except for those relating to his investment in FWDA.

On April 23, 1987, Barry C. Feldman (Mr. Feldman) of Mintz, Fraade & Zeiger, P.C., filed an entry of appearance for petitioner in this case. On August 13, 1987, Frederick M. Mintz and Jay L. Zeiger, both of Mintz, Fraade & Zeiger, also filed entries of appearance for petitioner. On January 7, 1988, the Court granted Mr. Kuntz's motion to withdraw as counsel.

On December 30, 1987, Sharon Katz-Pearlman (who was at the time the Government's project attorney for the Petro-Tech National Litigation Project), mailed a letter to Mr. Feldman, petitioner's attorney, with respect to the Petro-Tech cases, which clearly outlined the terms of the

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[5]On December 27, 1991, Mr. Bernsley entered his appearance in this case on behalf of Roscoe C. Webb, Jr. At that time Lydia M. Webb was no longer a party to this case.

settlement offer for each of the Petro-Tech cases. The letter stated as follows:

> In the event that the administrative files do not indicate that the offer was made prior to the filing of the Tax Court petition, your firm will have thirty (30) days from the date of filing with the Tax Court (as indicated by the filing date stamped on the petition by the Tax Court) in which to provide this office with an acceptance of the offer *and* the necessary substantiation. If this information is not received within the thirty (30) day period, the offer shall be deemed rejected by the petitioner and will not be renewed. Please note that there will be *no* exceptions to this procedure and that it will be firmly adhered to by this office.

Neither Mr. Feldman nor petitioner replied to this letter.

On February 3, 1988, while this case was pending in this Court, Revenue Agent Rochelle Ramirez mailed a letter to petitioner and Mrs. Webb from the Los Angeles District Office (hereinafter the February 3 letter). In the letter petitioners were informed that their 1982 Federal income tax return had been selected for examination as a result of their status as investors in FWDA. The letter further invited them to settle certain aspects of petitioner's FWDA investment. The offer stated:

> [the taxpayer] will be allowed a deduction in the initial year of the partnership in the amount of 75% of [the taxpayer's] total out-of-pocket; [the taxpayer] will concede all deductions arising from the partnership for all years. The government will concede the penalties pursuant to I.R.C. section 6653(a), 6659 and 6661; [the taxpayer] must concede the increased interest rate pursuant to I.R.C. section 6621(c).

Petitioner was further informed that, if he accepted the offer, the IRS "will furnish [him] with either a Form 870-AD and/or Closing Agreement."[6]

Enclosed with the February 3 letter was a form that provided petitioner with the opportunity to either accept or reject respondent's settlement offer. On April 13, 1988, petitioner signed the form but failed to indicate whether he accepted or rejected the settlement. He did, however, attach copies of three checks indicating that he had contributed $30,000, $30,440.56, and $32,800 to FWDA on December 10, 1981, March 1, 1982, and February 28, 1983, respectively.

On May 26, 1988, petitioner executed a Form 906, "Closing Agreement on Final Determination Covering Specific Matters" (the closing agreement) with respect to tax year 1981. On June 3, 1988, Leslie McKinney, a revenue agent, and an IRS section chief (whose signature on the closing agreement is illegible), in the Los Angeles district office signed the Form 906 on behalf of the Commissioner. The substantive terms of the closing agreement were similar to the offer proposed in the February 3 letter.[7]

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[6]There is no evidence in the record that the revenue agent who mailed this letter knew that petitioner's 1981 tax year was at the time involved in a case pending before this Court.

[7]The closing agreement states in pertinent part:

> The Taxpayers are entitled to an ordinary deduction in the amount of $69,930 for the taxable year ending December 31, 1981, with respect to their investment in the Partnership. Said amount represents 75% of their cash investment in the Partnership.
>
> * * * * *
>
> No penalty shall be assessed against the Taxpayers for the taxable year ended December 31, 1981 or any subsequent taxable year by reason of the disallowance of any losses claimed as a result of their interest in the Partnership. The increased interest rate pursuant to I.R.C. sec. 6621(c) shall apply.

On June 8, 1988, the Court set August 8, 1988, as the trial date for petitioner's case. On July 7, 1988, the Court granted respondent's motion for leave to file an amendment to her answer. Thus, the amendment to answer was filed, in which respondent raised the additions to tax pursuant to sections 6653(a)(1) and (2) and 6659, and additional interest pursuant to section 6621(c).

During the trial, the closing agreement was not brought to the Court's attention by petitioner, his counsel, or respondent's counsel.[8] The Memorandum Findings of Fact and Opinion, T.C. Memo. 1990-556, was filed on October 25, 1990. Our decision was entered on April 10, 1991.

The first time the Court became aware of the closing agreement's existence was on December 27, 1991 (more than 8 months after the decision was entered), when newly retained counsel for petitioner, Mr. Bernsley, filed a motion for leave to file a motion to vacate the decision.[9] In the motion petitioner argued that the Court had exceeded its jurisdiction by "disregarding" the closing agreement, and

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[8] Petitioner was subpoenaed by respondent and testified at the trial.

[9] Respondent's counsel apparently had no knowledge of the existence of the closing agreement until Mr. Bernsley informed the Manhattan District Counsel of its existence by telephone on December 2, 1991. There is no evidence in the record as to whether any of petitioner's prior counsel had knowledge of the closing agreement. In Mr. Bernsley's Feb. 26, 1992, affidavit he states as follows:

> I have also discussed this matter with Alan Fraade, petitioner's former attorney. He advised me that he was unaware of the Closing Agreement. I attempted to secure a Declaration from Alan Fraade, however, he has been uncooperative. After promising to execute a declaration, he failed to do so and has not taken or returned my telephone calls.

The Court is perplexed as to why petitioner, or his former counsel, if they knew, withheld such vital information from the Court. There was a duty and obligation to do so if petitioner intended to rely on the provisions of the closing agreement.

that such unauthorized action provided grounds for vacating the decision. Petitioner further asserted that the Court was obligated to vacate its decision because respondent's "failure" to inform the Court of the closing agreement constituted a fraud on the Court.

On February 3, 1992, respondent objected to this motion. Respondent argued that petitioner had shown neither that there had been fraud on the Court nor that the Court lacked jurisdiction to enter its decision. In any event, respondent contended that the closing agreement was invalid because it had not been executed by an individual with sufficient authority to bind the IRS. Respondent relied on paragraph 4 of Delegation Order No. 97 and Delegation Order LA-189 (see *infra* at 12). The former grants authority to certain examination and revenue personnel to enter into closing agreements, but specifically limits that authority by excluding cases docketed before the Tax Court. The latter is a redelegation by the Los Angeles District Director to certain lower level officials of the authority to execute closing agreements but with the exception that such authority does not extend to taxable periods at issue in cases pending before the Tax Court.

On February 27, 1992, petitioner replied to respondent's objection. Among other things, petitioner contended that the closing agreement was valid pursuant to Delegation Order No. 225.

As stated above, on March 17, 1992, we denied petitioner's motion for leave to file the motion to vacate the decision. On May 11, 1992, petitioner appealed our decision, and on February 14, 1994, the United States Court of Appeals for the Ninth Circuit remanded the case for consideration and disposition of the motion to vacate. Although the parties were given an opportunity to have a hearing on this motion, they declined the Court's invitation, stating that

they preferred to have the issues decided on the submitted affidavits and briefs.

We note that on October 29, 1992, respondent issued a Tax Equity and Fiscal Responsibility Act penalty-only notice of deficiency to petitioner and Lydia M. Webb relating to petitioner's 1984 investment in FWDA. Respondent conceded the additions to tax for negligence. The agreement of the parties is reflected in the Decision Document for docket No. 24771-92.

III. *Discussion*

A. *Delegated Authority to Enter Into Closing Agreement in Docketed Tax Court Case*

We must first decide whether respondent's agents possessed delegated authority to enter into a closing agreement with respect to a tax year (1981) that was at issue in an already-docketed Tax Court case. Respondent contends that the closing agreement was not binding because both the revenue agent and the section chief who signed the closing agreement lacked actual authority to do so. Petitioner on the other hand contends that the section chief both held himself out as having the authority to sign the closing agreement and, in fact, had authority to bind the IRS.

The delegation of authority to execute closing agreements is statutory. Section 7121(a) authorizes the Secretary of the Treasury or his delegate to enter into closing agreements with respect to the tax liability of any person for any taxable period.

This Court has repeatedly declined to enforce a settlement agreement where the person entering into the agreement on behalf of the Commissioner lacked the authority to bind the Commissioner. *Estate of Jones v. Commissioner*, 795 F.2d 566 (6th Cir. 1986), affg. T.C. Memo. 1984-53; *Dorl v. Commissioner*, 507 F.2d 406, 407 (2d Cir. 1974),

affg. per curiam T.C. Memo. 1973-145; *Gardner v. Commissioner*, 75 T.C. 475 (1980); *Cole v. Commissioner*, 30 T.C. 665, 674 (1958), affd. per curiam 272 F.2d 13 (2d Cir. 1959); *Baratelli v. Commissioner*, T.C. Memo. 1994-484; *David v. Commissioner*, T.C. Memo 1993-621; *Ginella v. Commissioner*, T.C. Memo. 1991-625. In other words, a closing agreement is not binding if the agents who executed the agreement on the Commissioner's behalf did not have the delegated authority to do so. *Botany Worsted Mills v. United States*, 278 U.S. 282, 288-289 (1929); *Klein v. Commissioner*, 899 F.2d 1149, 1153 (11th Cir. 1990); *Estate of Jones v. Commissioner, supra* at 571 n.3; *Reimer v. United States*, 441 F.2d 1129, 1130 (5th Cir. 1971).

1. *Delegation Order No. 97*

Delegation Order No. 97 (Rev. 27), effective October 31, 1987, Handbook of Delegation Orders, Internal Revenue Manual (CCH), sec. 1229-31 (amended and supplemented by Delegation Order No. 225, *infra* pp. 15-16), is entitled "Closing Agreements Concerning Internal Revenue Tax Liability". Delegation Order No. 97 authorizes certain examination and revenue personnel to enter into closing agreements. However, it specifically limits that authority by excluding cases docketed before the Tax Court.[10] The pertinent language of Delegation Order No. 97 is as follows:

> 4. The Assistant Commissioner (International); Regional Commissioners; Regional Counsel; Assistant Regional Commissioners (Examination); Service Center Directors; District Directors; Chiefs and Associate Chiefs of Appeals Offices; and Appeals Team Chiefs with respect to his/her team cases, are hereby

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[10]See sec. 301.7121-1(d)(1), Proced. & Admin. Regs., which provides that a request for a closing agreement may be made at any time "before a case with respect to the tax liability involved is docketed in the Tax Court of the United States."

> authorized *in cases under their jurisdiction (but excluding cases docketed before the United States Tax Court)* to enter into and approve a written agreement with any person relating to the Internal Revenue tax liability of such person (or of the person or estate for whom he/she acts) for a taxable period or periods ended prior to the date of agreement and related specific items affecting other taxable periods. [Emphasis added.]

Petitioner argues that the phrase "excluding cases docketed before the United States Tax Court" modifies the phrase "cases under their jurisdiction." He contends that the exclusion language limits who can settle docketed cases, not who can settle limited issues which may be present in several years. Here, petitioner continues, the "case" under the Examination Division's jurisdiction was petitioner's 1982 liability, a year *not* before the Court. In connection with the resolution of that liability, petitioner and the IRS entered into the closing agreement regarding 1981 (the docketed year). Because 1982 was not a docketed year, petitioner argues, the closing agreement was valid. In sum, petitioner contends that because Delegation Order No. 97, *supra* does not limit the other taxable periods which may be affected by the resolution of a specific issue, the validity of the closing agreement is not undermined.

Respondent disagrees. The closing agreement, respondent argues, is not binding in any way with respect to issues that were docketed before the Tax Court. It is stressed that the phrase "excluding cases docketed before the United States Tax Court" stands on its own and applies to all issues involved in a docketed Tax Court case. Accordingly, respondent contends that the revenue agent and section chief lacked authority under Delegation Order No. 97, *supra* to enter into the closing agreement with respect to any matter before the Court concerning petitioner's 1981 tax year.

We agree with respondent. Based upon the plain and unambiguous language of Delegation Order No. 97, *supra* it is clear that the Examination Division's agents lacked authority to enter into a closing agreement with respect to any matter pending before the Tax Court. The closing agreement at issue attempted to do just that when it addressed petitioner's 1981 tax year.[11] Thus, pursuant to Delegation Order No. 97, *supra* the closing agreement is invalid to the extent that it attempted to affect a tax year (1981) that was already before the Tax Court in a docketed case. Respondent's agents simply lacked authority under Delegation Order No. 97, *supra* to enter into an agreement for petitioner's 1981 tax year once it was docketed in this Court.

2. *Delegation Order No. LA-189*

Delegation Order No. LA-189 (Rev. 4), effective March 3, 1986, is a redelegation of Delegation Order No. 97, *supra* from the Los Angeles District Director to designated officials. Similar to Delegation Order 97, this delegation order also specifically excludes respondent's agents from entering into closing agreements with respect to cases docketed before the Tax Court.[12] For the reasons stated above, we conclude that the revenue agent and section chief who signed the closing agreement on behalf of

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[11] We note that based on the agreement of the parties, as set forth in the Decision Document of docket No. 24771-92, respondent conceded the additions to tax for petitioner's 1984 tax year. However, petitioner's 1984 tax year is irrelevant to the case before us.

[12] Deleg. Order No. LA-189 (Rev. 4) states in pertinent part:

> * * * the incumbents of, and persons acting in, the positions listed below are authorized, *in cases under their jurisdiction (but excluding cases docketed before the United States Tax Court)* to enter into and approve a written agreement with any person relating to the Internal Revenue tax liability of such person (or of the person or estate for whom he/she acts) for a taxable period or periods ended prior to the

the IRS did not have the authority to bind the Commissioner under Delegation Order No. LA-189 because the case was docketed before the Tax Court at the time the closing agreement was executed.

3. *Delegation Order No. 225*

Delegation Order No. 97, *supra* was amended and supplemented by Delegation Order No. 225 (Rev. 1), 52 Fed. Reg. 13008 (April 29, 1987), effective October 31, 1987. Delegation Order No. 225 delegates to certain examination officials, among others, the authority to execute closing agreements in cases involving certain tax shelters "where the initial investment was made prior to January 1, 1983."[13]

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date of agreement, and related specific items affecting other taxable periods.

Quality Review Division
Chief of the Division
Assistant Chief of the Division
Section Chiefs

Examination Division
Chief of the Division
Assistant Chief of the Division
Field Examination Branch Chiefs
Office Examination Branch Chiefs
Tax Shelter Program Manager
[Emphasis added.]

[13]The pertinent language of Deleg. Order No. 225 (Rev. 1), 52 Fed. Reg. 13008 (April 29, 1987) is as follows:

1. The Assistant Commissioners (Examination) and (International), Assistant Regional Commissioners (Examination), and Examination Managers and Supervisors GM-13 and GM-14 in Districts, Service Centers and Compliance Center are hereby authorized *in cases under their jurisdiction* to enter into and approve a written agreement with any person relating to the Internal Revenue liability, of such person (or of the person or estate for whom he/she acts) to close pre-ERTA tax shelter commodity issues, based on the Servicewide administrative positions developed by Appeals, Chief Counsel, and Examination, and

The language of Delegation Order No. 225 is silent as to docketed Tax Court cases. However, Delegation Order No. 225 amended and supplemented Delegation Order No. 97, *supra*. Thus, both Delegation Orders must be read in unison. By doing so, it is clear that respondent's agents are specifically excluded from entering into closing agreements with respect to tax shelter cases (where the initial investment was made prior to January 1, 1983) which are docketed before the Tax Court. Because this case was already docketed in the Tax Court at the time the closing agreement was executed, the revenue agent and section chief who executed the closing agreement did not have the authority to bind the Commissioner with regard to petitioner's 1981 tax year.

In sum, it is clear that respondent's agents did not possess authority under Delegation Order 97, LA-189, or 225, to bind the Commissioner with regard to petitioner's 1981 tax year.

4. *Apparent Authority*

Petitioner argues that the revenue agent and section chief had apparent authority to enter into the closing agreement. Petitioner may have assumed that the revenue agent and section chief had authority to bind the Commissioner. See

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other tax shelter initiative issues based on settlement positions reached by Chief Counsel or Appeals on the specific shelter where the initial investment was made prior to January 1, 1983. These agreements will be executed on Form 870-AD, Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, and Form 906, Closing Agreement on Final Disposition Covering Specific Matters. The authority delegated herein extends only to tax shelter issues, including penalties or related statutory issues that must be adjusted due to settlement of the tax shelter issues. This authority, also extends to tax shelter issues on subsequent year returns where benefits from pre-1983 tax shelters are claimed.
[Emphasis added.]

Baker v. Commissioner, 24 T.C. 1021, 1024 (1955). However, it is the responsibility of those dealing with a Government agent to determine the extent of that agent's authority. *Boulez v. Commissioner*, 76 T.C. 209, 214 (1981), affd. 810 F.2d 209 (D.C. Cir. 1987). "[P]ersons dealing with an agent of the government must take notice of the limitations of his authority." *Bornstein v. United States*, 170 Ct. Cl. 576, 345 F.2d 558, 562 (1965); see *Graff v. Commissioner*, 74 T.C. 743, 762 (1980), affd. per curiam 673 F.2d 784 (5th Cir. 1982); *Midwest Motor Express, Inc. v. Commissioner*, 27 T.C. 167, 182 (1956), affd. 251 F.2d 405 (8th Cir. 1958); *Smale & Robinson, Inc. v. United States*, 123 F. Supp. 457, 465 (S.D. Cal. 1954).

An agent "cloaked only with apparent authority" cannot bind the United States. *Bornstein v. United States*, 345 F.2d at 562. The United States is not bound by an apparent settlement where an agent was without authority to compromise a taxpayer's tax liability. *Reimer v. United States*, 441 F.2d at 1130; see also *Klein v. Commissioner*, 899 F.2d at 1153.[14] Thus, even if petitioner assumed that the revenue agent and section chief had apparent authority to enter into the closing agreement, such apparent authority does not translate into actual authority and cannot bind the IRS.

Accordingly, we hold that respondent's agents lacked the delegated authority to enter into the closing agreement with respect to petitioner's 1981 tax year. The closing agreement was therefore null and void.

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[14]It does not matter whether the agent knew the scope of his authority. See *Heckler v. Community Health Serv., Inc.*, 467 U.S. 51, 63 n.17 (1984) ("anyone entering into an arrangement with the Government takes the risk of having accurately ascertained that he who purports to act for the government stays within the bounds of his authority. * * * And this is so even [where] the agent himself may have been unaware of the limitations upon his authority." (quoting *Federal Crop Insurance Corp. v. Merrill*, 332 U.S. 380, 384 (1947)).

B. *Section 7121(b) and Rule 39*

Even if the closing agreement were valid, it is our view that section 7121(b)[15] does not permit the parties in a docketed Tax Court case to limit this Court's jurisdiction by way of a closing agreement that is not specially pleaded pursuant to Rule 39 as an avoidance or affirmative matter prior to trial, opinion, and decision. Petitioner contends that the Court is obligated to vacate its otherwise final decision if the decision is inconsistent with the closing agreement entered into pursuant to section 7121(b). To the contrary, respondent contends that the Court's jurisdiction is not limited by a closing agreement that is not affirmatively pleaded and accepted by the Court.

The Tax Court possesses only such jurisdiction as is conferred upon it by the Internal Revenue Code. See *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418, 422 (1943); *Jefferson Loan Co. v. Commissioner*, 249 F.2d 364, 366 (8th Cir. 1957), affg. an Order of this Court dated May 25, 1956; *Estate of Kahn v. Commissioner*, 60 T.C. 964, 968 (1973); *Burns, Stix Friedman & Co. v.*

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[15] Sec. 7121(b) states as follows:

SEC. 7121. CLOSING AGREEMENTS.

* * * * * * * *

(b) FINALITY. — If such agreement is approved by the Secretary (within such time as may be stated in such agreement, or later agreed to) such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact —

(1) the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer, employee, or agent of the United States, and

(2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

Commissioner, 57 T.C. 392, 396 (1971). Pursuant to sections 7481 and 7483, a Tax Court decision becomes final "Upon the expiration of the time allowed for filing a notice of appeal, if no such notice has been duly filed within such time". Sec. 7481(a)(1). The notice of appeal must be filed within 90 days. Sec. 7483. Where no appeal is taken, the Tax Court's decision becomes final 90 days after the entry of the decision. A motion to vacate must be filed "within 30 days after the decision has been entered, unless the Court shall otherwise permit." Rule 162.

The decision in this case was entered on April 10, 1991, and the decision became final on July 9, 1991. Petitioner's motion for leave to file motion to vacate decision out of time was filed with the Court on December 27, 1991, more than 5 months after the decision became final. There is no question that petitioner's motion was untimely.

Once a decision becomes final, the Tax Court lacks jurisdiction to reconsider either the decision or its underlying merits. *Lasky v. Commissioner*, 352 U.S. 1027 (1957);[16] *Abatti v. Commissioner*, 859 F.2d 115, 117 (9th Cir. 1988), affg. 86 T.C. 1319 (1986); *Toscano v. Commissioner*, 441 F.2d 930 (9th Cir. 1971). One exception to this general rule is that the Tax Court has jurisdiction to reconsider a final decision if fraud was perpetrated on the Court. *Billingsley v. Commissioner*, 868 F.2d at 1085; *Abatti v. Commissioner*, supra at 119.[17] A second exception is that the Tax

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[16] In *Lasky v. Commissioner*, 352 U.S. 1027 (1957), the Supreme Court affirmed per curiam a decision of the United States Court of Appeals for the Ninth Circuit (where an appeal in this case would lie), holding that the Tax Court lacks jurisdiction to grant a motion to vacate decision after the decision has become final. See *Lasky v. Commissioner*, 235 F.2d 97 (9th Cir. 1956).

[17] On remand, petitioner does not argue that fraud was perpetrated on the Court. "Fraud on the court must involve 'an unconscionable plan or scheme which is designed improperly to influence the court in its

Court has jurisdiction to reconsider a final decision where the Court may have lacked jurisdiction to enter the decision. *Billingsley v. Commissioner, supra.*[18]

The provisions that govern the finality of Tax Court decisions have been strictly construed. *Toscano v. Commissioner, supra* at 932. "Exceptions which would allow final decisions to be reconsidered must be construed narrowly in order to preserve the finality of judgments." *Abatti v. Commissioner*, 859 F.2d at 119. To permit the reopening of Tax Court final decisions would "inundate the courts with litigation respecting stale claims." *White's Will v. Commissioner*, 142 F.2d 746, 750 (3d Cir. 1944) affg. 40 B.T.A. 664 (1939).

Petitioner challenges the finality of our April 10, 1991, decision by arguing that we must vacate the decision because our jurisdiction was limited by the terms and conditions of his closing agreement with respondent. He bears the burden of proof on this issue. See *Abeles v. Commissioner*, 90 T.C. 103, 106 (1988).

It is a long-settled principle that where, as here, a notice of deficiency is timely mailed to the taxpayer, and the taxpayer files a timely petition in the Tax Court seeking a

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decision.' " *Abatti v. Commissioner*, 859 F.2d 115, 119 (9th Cir. 1988) (quoting *Toscano v. Commissioner*, 441 F.2d 930, 934 (9th Cir. 1971), affg. 86 T.C. 1319 (1986)). As the moving party, petitioner would have borne the burden to establish fraud by clear and convincing evidence. See *England v. Doyle*, 281 F.2d 304, 309-310 (9th Cir. 1960).

[18] A third exception to the finality rule is where the Tax Court's decision was based on mutual mistake. See, e.g., *Reo Motors, Inc. v. Commissioner*, 219 F.2d 610 (6th Cir. 1955). However, the Court of Appeals for the Ninth Circuit, where an appeal in this case would lie, has declined to recognize this exception. *Billingsley v. Commissioner*, 868 F.2d 1081, 1084 n.11 (9th Cir. 1989); *Abatti v. Commissioner, supra* at 118, affg. 86 T.C. 1319 (1986). Therefore, we will not discuss this exception.

redetermination of the determined deficiency, the taxpayer has voluntarily invoked the exclusive jurisdiction of this Court for such redetermination. See secs. 6213(a), 6512(a), 7442; see also *Gustafson v. Commissioner*, 97 T.C. 85 (1991); *Dorl v. Commissioner*, 57 T.C. 720, 721-722 (1972), affd. per curiam 507 F.2d 406 (2d Cir. 1974); *Southern Cal. Rock & Gravel Co. v. Commissioner*, 26 B.T.A. 296, 299 (1932). A taxpayer may not unilaterally oust the Tax Court of jurisdiction. Jurisdiction continues unimpaired until the function of the Court is either superseded by authorized action of another Court or is terminated by entry of decision or dismissal. See, e.g., *Main-Hammond Land Trust v. Commissioner*, 17 T.C. 942, 956 (1951), affd. 200 F.2d 308 (6th Cir. 1952); *Browning v. Commissioner*, T.C. Memo. 1974-80.

The execution of a closing agreement after we have obtained subject matter jurisdiction over a taxable year, even if the closing agreement is valid, does not divest the Court of its jurisdiction over a taxable year that has been properly placed before the Court through a valid notice of deficiency and a timely petition. In such a case the closing agreement is simply an agreement between two parties entered into without the Court's approval.

In *Browning v. Commissioner, supra*, we held that an agreement between the IRS and the taxpayer as to the amount of deficiencies and additions to tax owed did not deprive this Court of jurisdiction. We stated:

> After jurisdiction has vested in this Court an agreement by the parties on the amount of the deficiencies does not deprive this Court of power to determine the amount of the deficiency, if any, unless and *until the settlement agreement is filed with the Court and decision is entered in accordance therewith*; nor does execution by petitioners of a waiver of restrictions on immediate assessment and collection of the deficiencies

> agreed upon vitiate this Court's jurisdiction. *United States v. Shepard's Estate*, 196 F. Supp. 281, 284, affirmed as modified on other issues 319 F.2d 699. [Emphasis added.]

See also *Estate of Jones v. Commissioner*, 795 F.2d 566, 573 (6th Cir. 1986), affg. T.C. Memo. 1984-53. Similarly, we think that the execution of a closing agreement after a case is docketed in the Tax Court does not deprive us of subject matter jurisdiction or limit our jurisdiction.

Petitioner had a duty to the Court (and to his attorney) to disclose the existence of the closing agreement.[19] Petitioner is a highly educated person (a surgeon) with knowledge of business and financial affairs. We do not accept his explanation that he was unable to comprehend the meaning and consequences of the closing agreement at the time he executed it. Petitioner has failed to carry his burden of proving facts necessary to establish that we must vacate our April 10, 1991, decision because our jurisdiction was limited by the terms and conditions of the closing agreement.

In order for a valid closing agreement to have been properly before the Court, and hence enforceable by the Court, petitioner should have affirmatively pleaded such matter. The closing agreement, by itself, did not deprive the Tax Court of jurisdiction. See *Browning v. Commissioner*, *supra*. This Court will decline to decide issues that are not raised by the notice of deficiency unless they are raised in the pleadings or by an amendment to the pleadings. *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. 708 (1981). "Time and again this Court has reiterated that we will not consider issues not raised in the pleadings." *Rollert Residu-*

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[19] Again, it is not clear from the record whether petitioner informed his former attorneys of the closing agreement's existence. If he did, then the attorneys should have informed the Court if the closing agreement was believed to be valid.

ary Trust v. Commissioner, 80 T.C. 619, 636 (1983), affd. 752 F.2d 1128 (6th Cir. 1985). See also, e.g., *Winnett v. Commissioner*, 96 T.C. 802, 806 (1991); *Markwardt v. Commissioner*, 64 T.C. 989, 997 (1975); *Estate of Mandels v. Commissioner*, 64 T.C. 61, 73 (1975); *Frentz v. Commissioner*, 44 T.C. 485, 491 (1965), affd. without discussion of this issue 375 F.2d 662 (6th Cir. 1967); *Isenbergh v. Commissioner*, 31 T.C. 1046, 1057 (1959); *Holahan v. Commissioner*, 21 T.C. 451, 465 (1954), affd. 222 F.2d 82 (2d Cir. 1955); *Kutsunai v. Commissioner*, T.C. Memo. 1983-182.

In order for us to have considered the closing agreement, even if valid, petitioner should have affirmatively pleaded its terms and conditions as a special matter. See *Estate of Shedd v. Commissioner*, 320 F.2d 638, 641 (9th Cir. 1963), affg. 37 T.C. 394 (1961). Rule 39 provides:

> A party shall set forth in the party's pleading any matter constituting an avoidance or affirmative defense * * *. A mere denial in a responsive pleading will not be sufficient to raise any such issue.

Prior to trial, petitioner had ample opportunity to affirmatively plead the existence of the closing agreement. He failed to do so.

We note that petitioner's argument that we "exceeded" our jurisdictional mandate is tantamount to asserting that our decision was erroneous or contrary to the decision we may have been obligated to enter. However, "Even erroneous decisions become final under [section] 7481 if no appeal is filed within the allotted time." *Abatti v. Commissioner*, 859 F.2d 115, 119 (9th Cir. 1988), affg. 86 T.C. 1319 (1986); cf. *Billingsley v. Commissioner*, 868 F.2d 1081, 1084 (9th Cir. 1989) ("a decision which never becomes final, as opposed to a decision which is final but was entered erroneously, can be the subject of a motion to vacate even

after the expiration of the time for appeal set forth in [section] 7483") (emphasis added).[20]

Here respondent sent petitioner a timely notice of deficiency, petitioner filed a timely petition, and the Tax Court acquired jurisdiction over the case. Thus, even if the decision entered on April 10, 1991, was "unauthorized" in view of the closing agreement's existence, the decision did not become a nullity. It became final 90 days later. Petitioner's remedy was to file his motion to vacate, or a notice of appeal, before the decision became final, especially where he knew of the closing agreement's existence. See *Crews v. Commissioner*, 120 F.2d 749, 751 (10th Cir. 1941). The statutes regarding the finality of decisions would be rendered useless if final decisions could be reviewed every time a party alleges a Court error.

We conclude that, even if the closing agreement were valid, section 7121(b) does not permit petitioner in his docketed 1981 Tax Court case to limit the Court's jurisdic-

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[20] Fed. R. Civ. Proc. 60(b)(4) authorizes a court to grant relief from a judgment that is "void". Pursuant to this rule, a judgment is not void merely because it grants an unauthorized remedy; rather, the court must have totally lacked jurisdiction over the class of case involved. The Tax Court may follow and give weight to the Federal Rules of Civil Procedure. Rule 1(a).

> Where * * * the court has jurisdiction over the class of case involved, its judgment is not void, and hence is not subject to collateral attack, on the ground * * * that the right involved in the suit did not embrace the relief granted. In brief, then, except for the rare case where power is plainly usurped, if a court has the general power to adjudicate the issues in the class of suits to which the case belongs, then its interim orders and final judgments, whether right or wrong, are not subject to collateral attack, so far as jurisdiction over the subject matter is concerned. [Fn. ref. omitted.]

7 Moore's Federal Practice sec. 60.25[s] (2d Ed. 1991) (footnotes omitted); see also *Honneus v. Donovan*, 691 F.2d 1 (1st Cir. 1982).

tion by the execution and terms of a closing agreement which has not been specially pleaded pursuant to Rule 39.

To reflect the foregoing,

Petitioner's Motion to Vacate Decision will be denied.

NOT FOR PUBLICATION

No. 92-70344

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ROSCOE C. WEBB, JR.,
Petitioner-Appellant,
v.
COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Tax Ct. No. 11415-85

MEMORANDUM*

FILED
Feb 14 1994
CATHY A. CATTERSON, CLERK
U.S. COURT OF APPEALS

Appeal from a Decision of the
United States Tax Court

Argued and Submitted October 7, 1993
Pasadena, California

Before: HALL and RYMER, Circuit Judges, and FITZGERALD, District Judge.

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*This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

**The Honorable James M. Fitzgerald, Senior United States District Judge for the District of Alaska, sitting by designation.

The Tax Court denied leave to file Webb's motion to vacate. The Tax Court had jurisdiction to consider the motion, although untimely filed, because the motion sought "to vacate [the Tax Court's] original decision for lack of jurisdiction." *Billingsley v. Commissioner*, 868 F.2d 1081, 1085 (9th Cir. 1989). Accordingly, we REMAND to the Tax Court with instructions to grant leave to file the motion to vacate.

Docket No. 11415-85

UNITED STATES TAX COURT
Washington, D.C. 20217

ROSCOE C. WEBB, JR.
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ORDER

On December 27, 1991, petitioner filed a Motion for Leave to File Motion to Vacate Decision and lodged with the Court a Motion to Vacate Decision.

The Memorandum Findings of Fact and Opinion (T.C. Memo. 1990-556) herein was filed on October 25, 1990, and the Decision was entered on April 10, 1991. No notice of appeal of the decision was filed within the 90-day period provided in section 7483, Internal Revenue Code, and the decision became final. Petitioner was represented by counsel, Frederick M. Mintz, Jay L. Zeiger, and Alan P. Fraade, during such period.

On February 3, 1992, respondent filed a notice of objection to petitioner's motion for leave to file his motion to vacate out of time; and on February 27, 1992, petitioner filed a reply to respondent's notice of objection.

After due consideration, and petitioner having failed to show any fraud on this Court, mutual mistake or lack of subject matter jurisdiction, we conclude that there is no factual or legal basis for vacating and setting aside the final decision of this Court. See *Lasky v. Commissioner*, 235 F.2d 97 (9th Cir. 1956) affd. 352 U.S. 1027 (1957); *Toscano v. Commissioner*, 441 F.2d 930 (9th Cir. 1971); *Kenner v. Commissioner*, 387 F.2d 689 (7th Cir. 1968); *Reo Motors, Inc. v. Commissioner*, 279 F.2d 610 (6th Cir. 1955); *Senate*

Realty Corporation v. Commissioner, 511 F.2d 929 (2nd Cir. 1975); *Abatti v. Commissioner*, 859 F.2d 115 (9th Cir. 1988); and *Billingsley v. Commissioner*, 868 F.2d 1081 (9th Cir. 1989). Accordingly, it is

ORDERED: That petitioner's Motion for Leave to File Motion to Vacate Decision is denied.

/s/ HOWARD A. DAWSON, JR.
Howard A. Dawson, Jr.
Judge

Dated: Washington, D.C.
March 17, 1992

UNITED STATES TAX COURT

ROSCOE C. WEBB, JR.
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Document No. 11415-85
DW — Petro-Tech
Judge Gussis

DECISION

Pursuant to the opinion of the Court filed October 25, 1990, and incorporating herein the facts recited in the respondent's computation and the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1981 in the amount of $69,363.00;

That there is an addition to the tax due from the petitioners for the taxable year 1981, under the provisions on I.R.C. § 6653(a)(1) in the amount of $3,468.15, such claim made pursuant to provisions of section 6214(a);

That there is an addition to the tax due from the petitioners for the taxable year 1981, under the provisions of section 6653(a)(2), in the amount equal to 50 percent of the statutory interest due on $69,363.00 from April 15, 1982, the date of assessment of tax, or, if earlier, the date of payment, such claim made pursuant to provisions of section 6214(a); and

That the entire deficiency in income tax due from the petitioners for taxable year 1981 is a substantial underpayment attributable to a tax motivated transaction for the purposes of computing interest payable with respect to such amount pursuant to section 6621(c), formerly sec-

tion 6621(d), such claim made pursuant to provisions of section 6214(a).

/s/ HOWARD A. DAWSON, JR.
Judge

Entered: Apr 19, 1991

T.C. Memo. 1990-556

UNITED STATES TAX COURT

ROSCOE C. WEBB, JR., Et Al.[1],
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 11415-85, 36291-85, Filed October 25, 1990.
18029-86, ... 25683-86,
27578-86, ... 40464-86,
43921-86, ... 46308-86,
47752-86, ... 48498-86,
14440-87, ... 15064-87.

Frederick M. Mintz and *Jay L. Zeiger* for the petitioners.

Kevin M. Flynn, Sharon Katz-Pearlman, Curt Rubin, and *Jeannette Schmelzle,* for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DAWSON *Judge*: These consolidated cases were assigned for trial or other disposition to Special Trial Judge James M. Gussis pursuant to section 7443A(b) of the

[1]Cases of the following petitioners are consolidated herewith: Frank Dietrich, docket No. 36291-85; Nicholas L. Arky, docket No. 18029-86; Herman David and Sylvia David, docket No. 25683-86; Lester H. Strickler and E. Grace Strickler, docket No. 27578-86; George Tsakonas and Ernestine Tsakonas, docket No. 40464-86; Fred J. Sherman and Leonora Sherman, docket No. 43921-86; Michael Sirkus, docket No. 46308-86; Estate of Aaron Bassin, Deceased, Ruth Bassin, Personal Representative, and Ruth Bassin, docket No. 47752-86; William R. Parient, Jr. and Jane M. Parient, docket No. 48498-86; Eugene and Leora Pitts, docket No. 14440-87; and Quaiser Bakht and Cresanta Bakht, docket No. 15064-87.

Internal Revenue Code and Rule 180 et seq.[2] This Court agrees with and adopts the opinion of the Special Trial Judge which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

GUSSIS, *Special Trial Judge*: Respondent determined the following Federal income tax deficiencies, additions to tax and increased interest:

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[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect for the years in issue, unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

Docket No.	Petitioners	Year	Deficiency	Increased Interest §6621(c)	Additions to Tax §6653(a)(1)	§6653(a)(2)	§6659	§6661
11415-85	Roscoe C. Webb, Jr.	1981	$69,363.00	—	—	—	—	—
36291-85	Frank Dietrich	1981	14,562.08	—	—	—	—	—
18029-86	Nicholas L. Arky	1981	24,394.00	applicable	$1,219.70	*	$7,318.20	—
		1982	12,881.00	applicable	644.05	**	3,752.70	$ 37.20
25683-86	Herman David & Sylvia David	1982	29,984.00	—	—	—	—	—
27578-86	Lester H. Strickler & E. Grace Strickler	1981	20,010.08	applicable	1,000.50	*	6,002.54	applicable
		1982	20,985.00	applicable	1,049.25	**	6,295.50	applicable

* 50 percent of the interest due on the underpayment of $24,394.00 attributable to negligence.

** 50 percent of the interest due on the underpayment of $12,881.00 attributable to negligence.

* 50 percent of the interest due on the underpayment of $20,010.08 attributable to negligence.

** 50 percent of the interest due on the underpayment of $20,985.000 attributable to negligence.

Docket No.	Petitioners	Year	Deficiency	Increased Interest §6621(c)	Additions to Tax §6653(a)(1)	§6653(a)(2)	§6659	§6661
40464-86	George Tsakonas .... & Ernestine Tsakonas	1981	15,614.75	applicable	—	—	4,684.43	—
43921-86	Fred J. Sherman .... & Leonora Sherman	1980	24,863.00	applicable	—	—	—	—
46308-86	Michael Sirkus.....	1980	28,040.00	applicable	—	—	—	—
		1981	27,285.00	applicable	—	—	8,186.00	—
		1982	30,859.00	applicable	—	—	9,258.00	applicable
47752-86	Estate of Aaron ..... Bassin, Deceased, Ruth Bassin, Personal Representative, & Ruth Bassin	1981	22,916.00	applicable	—	—	6,875,000	—
48498-86	William R. ..... Parient, Jr., & Jane M. Parient	1980	16,257.00	applicable	—	—	—	—
14440-87	Eugene & Leora .... Pitts	1982	37,282.00	applicable	—	—	5,900,000	—
15064-87	Quaiser Bakht & .... Cresanta Bakht	1980	21,879.22	applicable	—	—	—	—

Respondent, by way of amended answer, asserted the following: docket No. 11415-85, increased interest and additions to tax for the year 1981 under sections 6621(c), 6653(a)(1) and (2) and 6659; docket No. 36291-85, increased interest and additions to tax for the year 1981 under sections 6621(c), 6653(a)(1) and (2) and 6659; docket No. 25683-86, increased interest and additions to tax for the year 1982 under sections 6621(c), 6653(a)(1) and (2), 6659, and section 6661; docket No. 40464-86, additions to tax for 1981 under section 6653(a)(1) and (2); docket No. 48498-86, additions to tax for 1980 under section 6653(a); docket No. 14440-87, additions to tax for 1982 under sections 6653(a)(1) and (2) and 6661.

Respondent has now conceded that section 6659 is inapplicable to these cases. Respondent has also moved for the imposition of damages in each of these cases under the provisions of section 6673.

These cases were selected by the parties as test cases for the resolution of certain issues common to a large number of cases designated as the Petro-Tech group. Petitioners herein were investors in six of the limited partnerships which were involved in the Petro-Tech group, namely:

Limited Partnerships	Petitioners	Docket Nos.
Great Salt Lake Drilling Associates	Quaiser Bakht & Cresanta Bakht	15064-87
	Fred J. Sherman & Leonora Sherman	43921-86
Rocky Mountain Drilling Associates	Michael Sirkus	46308-86
	William R. Parient, Jr., & Jane M. Parient	48498-86
Far West Drilling Associates	George Tsakonas & Ernestine Tsakonas	40464-86
	Roscoe C. Webb, Jr.	11415-85

Limited Partnerships	Petitioners	Docket Nos.
Far West Drilling Associates II	Lester H. Strickler & E. Grace Strickler	27578-86
	Eugene & Leora Pitts	14440-87
Midcontinent Drilling Associates	Frank Dietrich	36291-85
	Estate of Aaron Bassin, Deceased, Ruth Bassin, Personal Representative, & Ruth Bassin	47752-86
Midcontinent Drilling Associates II	Herman David & Sylvia David	25683-86
	Nicholas L. Arky	18029-86

The issues in these consolidated cases are (1) whether the activities of each of the limited partnerships were entered into for profit within the meaning of section 183(a); (2) whether sublicense fees deducted by each of the limited partnerships were paid or incurred in connection with a trade or business within the meaning of sections 162 and 1253(d)(2); (3) whether deductions for the portion of the sublicense fees attributable to the notes which are payable to Mitchell Petroleum Technology Corporation should be disallowed; (4) whether the portion of the sublicense fees attributable to the recourse notes which were payable to Mitchell Petroleum Technology Corporation and were purportedly assumed by the individual partners should be included in each individual partner's at-risk basis pursuant to section 465; (5) whether the losses claimed by the individual partners are in excess of the amounts at risk in their respective limited partnerships pursuant to the provisions of section 465, or the basis in such partnerships pursuant to section 704(d); (6) whether the additions to tax under section 6653(a)(1) and (2) are applicable with respect to petitioners here involved; (7) whether petitioners are subject to the additions to tax pursuant to section 6661 for substantial understatement of tax liability; (8) whether

petitioners are subject to the increased interest provisions of section 6621(c) with respect to substantial underpayments attributable to tax-motivated transactions; and (9) whether petitioners are liable for a penalty pursuant to section 6673 because the proceedings herein were purportedly instituted primarily for delay or were frivolous in nature.

FINDINGS OF FACT

Some of the facts have been stipulated and they are herein incorporated by this reference.

Quaiser Bakht and Cresanta Bakht were residents of Wainscott, New York, at the time their petition herein was filed. Dr. Bakht has been a physician since 1955. Quaiser and Cresanta Bakht filed a timely joint Federal income tax return for the year 1980 in which they claimed a loss in the amount of $49,502 with respect to their investment in Great Salt Lake Drilling Associates which was disallowed by respondent.

Fred J. Sherman and Leonora Sherman were residents of Newport, California at the time their petition herein was filed. During the period at issue Mr. Sherman was in the export trading business and was president and principal owner of Searock Trading Corporation. Fred J. Sherman and Leonora Sherman filed a timely joint Federal income tax return for the year 1980 in which they claimed a loss in the amount of $49,503 with respect to their investment in Great Salt Lake Drilling Associates which was disallowed by respondent.

Michael Sirkus was a resident of New York, New York at the time his petition herein was filed. Mr. Sirkus is engaged in the wholesale seafood business. He filed timely Federal income tax returns for the years 1980, 1981, and 1982 in which he claimed losses in the respective amounts of $49,501, $53,075, and $59,639 with respect to his invest-

ment in Rocky Mountain Drilling Associates which respondent disallowed in full.

William R. Parient, Jr., and Jane M. Parient were residents of Lincolnshire Woods, Illinois, at the time their petition herein was filed. Mr. Parient is engaged in the profession of financial planning. In or about 1980 he was an executive of Anixter Brothers, Inc., a worldwide distributor of electrical wire and cable and various products for the cable television industry. William R. Parient, Jr., and Jane M. Parient filed a timely Federal income tax return for the year 1980 in which they claimed a loss of $49,502 with respect to their investment in Rocky Mountain Drilling Associates which was disallowed by respondent.

George Tsakonas and Ernestine Tsakonas were residents of Staten Island, New York, at the time their petition herein was filed. Dr. Tsakonas has been a physician for some 25 years. George Tsakonas and Ernestine Tsakonas filed a timely joint Federal income tax return for the year 1981 in which they claimed a loss of $52,017 with respect to their investment in Far West Drilling Associates which was disallowed by respondent.

Roscoe C. Webb, Jr., was a resident of Santa Monica, California, at the time his petition herein was filed. Dr. Webb has been a surgeon since the late 1950's. Dr. Webb filed a timely joint Federal return with his former wife for the taxable year 1981 in which they claimed a loss of $104,033 with respect to their investment in Far West Drilling Associates which was disallowed by respondent.

Lester H. Strickler and E. Grace Strickler were residents of Los Gatos, California, at the time their petition herein was filed. They filed a timely joint Federal income tax return for the years 1981 and 1982 in which they claimed losses in the respective amounts of $39,600 and $42,200 with respect

to their investment in Far West Drilling Associates II which were disallowed by respondent.

Eugene Pitts and Leora Pitts were residents of Waukegan, Illinois, at the time their petition herein was filed. Dr. Pitts, now retired, was a physician for many years. Eugene Pitts and Leora Pitts filed a joint Federal income tax return for the year 1982 in which they claimed a loss of $42,200 with respect to their investment in Far West Drilling Associates II which was disallowed by respondent.

Frank Dietrich was a resident of Toledo, Ohio, at the time his petition herein was filed. He filed a timely Federal income tax return for the year 1981 in which he claimed a loss of $36,528.46 with respect to his investment in Midcontinent Drilling Associates which was disallowed by respondent.

Aaron Bassin (now deceased) and Ruth Bassin were residents of Bethesda, Maryland, at the time their petition herein was filed. They filed a timely Federal income tax return for the year 1981 in which they claimed a loss of $37,104 with respect to their investment in Midcontinent Drilling Associates which was disallowed by respondent.

Herman David and Sylvia David were residents of Miami Beach, Florida, at the time their petition herein was filed. Mr. David has been engaged in the diamond business for many years. Herman David and Sylvia David filed a timely Federal income tax return for the year 1982 in which they claimed a loss of $64,451 with respect to their investment in Midcontinent Drilling Associates II which was disallowed by respondent.

Nicholas L. Arky was a resident of Denver, Colorado, at the time his petition herein was filed. He filed a timely Federal income tax return for the years 1981 and 1982 in which he claimed losses in the respective amounts of $39,600 and $42,967 with respect to his investment in

Midcontinent Drilling Associates II which were disallowed by respondent.

Herman Finesod is sole stockholder of M&J Holding Company (M&J) which holds the stock in various corporations including Jackie Fine Arts, Hambrose Leasing, Hambrose Stamps, Worldco Services Group, Petro-Tech, Mitchell Energy and Mitchell Petroleum Technology Corporation. Herman Finesod is president of said corporations. None of these companies is active at the present time except for certain continuing bookkeeping functions. James Haber, a certified public accountant, was secretary-treasurer of Mitchell Petroleum Technology Corporation.

Great Salt Lake Drilling Associates (GSLDA), a limited partnership, was formed under the laws of the State of Utah on October 10, 1980, and limited partnership interests therein were offered for sale pursuant to a confidential private placement memorandum dated November 18, 1980. Rocky Mountain Drilling Associates (RMDA), a limited partnership, was formed under the laws of the State of Utah on November 7, 1980, and limited partnership interests therein were offered for sale pursuant to a confidential private placement memorandum dated November 18, 1980. Far West Drilling Associates (FWDA), a limited partnership, was formed under the laws of the State of Utah on December 4, 1980, and limited partnership interests therein were offered for sale pursuant to a confidential private placement memorandum dated May 11, 1981. Far West Drilling Associates II (FWDA II) a limited partnership, was formed under the laws of the State of Utah on November 2, 1981, and limited partnership interests therein were offered for sale pursuant to a confidential private placement memorandum dated December 1, 1981. Midcontinent Drilling Associates (MCDA), a limited partnership, was formed under the laws of the State of Utah on December 4, 1980, and limited partnership interests therein

were offered for sale pursuant to a confidential private placement memorandum dated January 31, 1981. Midcontinent Drilling Associates II (MCDA II), a limited partnership, was formed under the laws of the State of Utah on December 4, 1980, and limited partnership interests therein were offered for sale pursuant to a confidential private placement memorandum dated October 26, 1981. Each of the above limited partnerships had an individual and a corporate general partner.

Quaiser Bakht is a physician. He learned about the GSLDA program from one Carmine Lopresti, a financial adviser. Dr. Bakht discussed the investment with his accountant and was told that the investment was risky, that it made sense on a long-term basis, and that it would entail losses in the short run. Dr. Bakht acquired his interest in GSLDA on December 17, 1980. He made a cash down payment of $12,500, executed two negotiable promissory notes, due March 1, 1981, and March 1, 1982, respectively, each in the amount of $12,500, and a nonnegotiable note in the amount of $112,500 due January 15, 1993. The due date of the nonnegotiable note was subsequently extended from 1993 to 1999.

Fred J. Sherman learned about GSLDA from his accountant. Mr. Sherman relied upon his accountant and his stepson, who was business manager of petitioner's trading corporation, in making the investment in GSLDA. Mr. Sherman acquired his interest in GSLDA in 1980. He made a cash down payment of $12,500, executed two promissory notes due March 1, 1981, and March 1, 1982, respectively, each in the amount of $12,500, and a nonnegotiable promissory note in the amount of $112,500 due January 15, 1993.

Michael Sirkus learned about RMDA from his accountant. Previously, Mr. Sirkus had invested in securities involving oil and gas drilling. His investments in Transcontinental

Oil and Petro-Lewis resulted in gains in 1980. He also invested in two limited partnerships, Normandy Square Associates and Southland Villas Associates. Mr. Sirkus acquired his interest in RMDA in 1980. He made a cash down payment of $12,500, executed two negotiable promissory notes due March 1, 1981, and March 1, 1982, respectively, each in the amount of $12,500, and executed a nonnegotiable promissory note in the amount of $112,500 due January 15, 1993.

William R. Parient, Jr., held a 50-percent partnership interest in a partnership known as 8220 Skokie Blvd. Building. The partnership acquired an interest in RMDA in December 1980, under the following terms: a cash down payment of $25,000, two negotiable promissory notes due March 1, 1981, and March 1, 1982, respectively, each in the amount of $25,000, and a negotiable promissory note in the amount of $225,000 due January 15, 1993.

George Tsakonas acquired an interest in FWDA in 1981. Dr. Tsakonas made a cash down payment of $15,000, executed two negotiable promissory notes due March 1, 1982, and March 1, 1983, respectively, each in the amount of $15,000, and an open obligation to FWDA of $112,500 payable January 15, 1994.

Roscoe C. Webb, Jr., a surgeon, learned about FWDA from his accountant. Dr. Webb acquired an interest in FWDA in 1981. He made a cash down payment of $30,000, executed two negotiable notes dated March 1, 1982, and 1983, respectively, each in the amount of $30,000. The balance of the purchase price, $225,000, was represented by an open account obligation to FWDA due in 1994.

Lester H. Strickler acquired an interest in FWDA II in 1981. He made a cash down payment of $10,000 and executed two promissory notes due March 1, 1982, and March 1, 1983, respectively, each in the amount of $10,000.

The balance of the purported purchase price of $150,000 was represented by an open account obligation to FWDA II in the amount of $120,000, payable in 1994.

Eugene Pitts acquired an interest in FWDA II in 1981 under the following terms: a cash down payment of $10,000, two negotiable promissory notes each in the amount of $10,000 due March 1, 1982, and March 1, 1983, respectively, and an open account obligation to FWDA II in the amount of $120,000 payable in 1994.

Frank Dietrich acquired an interest in MCDA in 1981 through his wholly owned subchapter S corporation, Seto, under the following terms: a cash down payment of $12,500, three negotiable promissory notes due March 1, 1982, 1983, and 1984, respectively, each in the amount of $12,500, and a nonnegotiable promissory note in the amount of $100,000 due January 15, 1994.

Aaron Bassin acquired an interest in MCDA in 1981. He made a cash down payment of $12,500, executed three promissory notes due March 1, 1982, 1983, and 1984, respectively, each in the amount of $12,500, and executed a nonnegotiable promissory note in the amount of $100,000 due January 15, 1994.

Herman David left all of his personal investment decisions to his children. Mr. David's son, Sheldon, learned about MCDA II from his accounting firm. Herman David acquired an interest in MCDA II in 1981. He made a cash down payment of $15,000, executed two negotiable notes due March 1, 1982, and 1983, respectively, each in the amount of $15,000, and arranged an open account obligation for an amount in excess of $100,000 payable in 1994.

Nicholas L. Arky acquired an interest in MCDA II in 1981. He made a cash down payment of $10,000, executed two negotiable promissory notes due March 1, 1982, and 1983, respectively, each in the amount of $10,000, and

arranged an open account obligation payable to MCDA II in the amount of $120,000 due in 1994.

Tround International, Inc., (hereinafter Tround) was incorporated in the State of Delaware on February 12, 1973, for the purpose of developing certain technology called the open chamber system. David Dardick, president and principal shareholder of Tround, invented the open chamber system as a weapon system suitable for military applications. Tround's principal office, from its inception in 1973 through December 31, 1982, was located at 211 East 70th Street, New York, New York, which address was the apartment of David Dardick. His son, Steven M. Dardick, was vice president and director of Tround in 1980 and he became a full-time employee of Tround in 1981. Prior to 1981, Steven M. Dardick (Dardick) was employed by TRW, Inc. (TRW), for a number of years in various capacities. From 1975 to 1980 Dardick was general manager of TRW's Turbine Components Plant which manufactured jet engine components. Dardick does not have a background in oil and gas drilling. John Milling, an attorney who has been associated with Tround since 1973, is chairman of the board of Tround and a stockholder of the corporation.

Tround is the owner of the outstanding patents and know-how which comprise the technology known as the open chamber system. The open chamber system is an ordinance or gun technology. The basic mechanism of an open chamber gun is a rotating gun cylinder with recesses cut in the side to accommodate the ammunition. The ammunition for the system is fed laterally into the chamber and as the gun cylinder rotates into the firing position, the chamber recess is closed by the fixed top structure of the main frame of the gun-type apparatus. Once secured by the main frame of the gun, a charge is ignited and the gases generated by the ignited substance project the projectile

forward through the barrel. The gun cylinder then rotates and ejects the spent cartridge to one side.

Tround undertook to adapt the open chamber system to the development of a deep-hole oil and gas drill assembly (hereinafter the Terra-Drill), which, by pre-fracturing rock with high velocity projectiles which fired, through triple gun barrels in advance of a modified conventional rotary drill bit, would enable the bit to penetrate through rock at a faster rate. The gun assembly included a magazine for storing the ammunition and, on top of the magazine, a power source and a gear drive system to operate the whole mechanism. The mechanism is housed in a so-called drill-skirt which is attached to and functions as part of the drill-string.

In oil field drilling operations, drilling fluid, commonly called mud, is customarily utilized in the borehole while drilling. Almost all oil and gas drilling is done with mud as the flushing medium. The mud is used to counterbalance formation pressure, support the borehole walls, cool the drill bit, and to serve as a medium to carry rock chip debris to the surface. In oil and gas drilling with the Terra-Drill in the mud environment a mud valve is required as part of the assembly to prevent mud from making the drill inoperative by entering the gun barrels and flooding the gun system. Tround has been unsuccessful in its efforts to develop a functioning mud valve for use in the field and its development is still in the laboratory stage. In an early development stage, Tround began automatic cycling testing with a ball-seal valve technique. With automatic cycling, the ball-seal did not move from the sealed position quickly enough to avoid contact with the fired projectile. If the projectile clipped the ball-seal, it would cause the gun barrel to explode. Tround also discovered that the ball-seal life, even when it was not clipped by projectiles, lasted only from 100 to 150 cycles, which would not be enough to empty the magazine on the gun assembly. Moreover, while laboratory

tests for the mud valve at simulated 10,000-foot pressures were partially successful, it was discovered that the ball-seal would not close satisfactorily at lower pressures.

In 1980, Tround was in financial straits and considered raising capital in a public offering of its stock through a registered broker/dealer, Norbay Securities, Inc. (Norbay). Ben Taormina was president of Norbay. Mr. Taormina suggested that financing for Tround might be available from Herman Finesod in connection with one of Mr. Finesod's proposed tax shelter projects. After discussions with Mr. Finesod, Tround decided to defer its public stock offering.

Mitchell Petroleum Technology Corporation (Mitchell) was formed on July 24, 1980, under the laws of the State of Delaware. On November 11, 1980, Tround and Mitchell entered into a license agreement which was amended several times. Under the terms of the agreement, Tround granted Mitchell during a designated period the exclusive right to use, lease and sell open chamber drills and triangular rounds therefor solely for the licensed use in the licensed territory. Licensed use is defined in the agreement as the exploration for and recovery of oil and gas only. Licensed territory consisted of the United States and Canada, but excluded certain portions of such territory in accordance with the provisions of the agreement. Section 4.2 of the agreement provided that the rights and licenses granted to Mitchell were subject to a reserved right and license in Tround to sell open chamber drills and triangular rounds anywhere in the licensed territory and for use therein. Section 6.6 of the agreement provided that all sales or rentals of the open chamber drills by Tround for licensed use in the United States and Canada, prior to the termination date of the agreement, would be at a minimum sales price of $100,000 per drill or at a rental reasonably based on such minimum sales price, together with a royalty payable to Tround by the

purchaser or renter of such drill in an amount not less than one percent of the selling price of all oil and gas recovered from wells which were sunk with the use of such drill. Pursuant to the license agreement, as amended, Tround, with the concurrence of Mitchell, was permitted to accept a larger rental in lieu of the payment of the 1-percent royalty.

Under section 7.1 of the original license agreement, Mitchell agreed to pay the full amount of a "cutoff license fee" of $2,000,000 to Tround by December 31, 1981. Mitchell also agreed to pay an advance license fee to Tround in the total amount of $1,600,000 ($100,000 previously paid, $500,000 on or before December 15, 1980, and $1,000,000 on or before January 15, 1981) which would be recovered by Mitchell by way of credits against future license fees payable by Mitchell under the agreement. An amendment to the license agreement dated January 15, 1981, verified that an advance license fee of $600,000 had heretofore been paid by Mitchell to Tround and further stated that Mitchell was obligated to pay additional amounts of $500,000 on March 20, 1981, and $500,000 on May 20, 1981. Section 7.1 of the license agreement was also amended as of January 15, 1981, as follows:

> 7.1(c) [Mitchell] agrees to assign to [Tround] if, as and when received, a portion of any notes it receives from its sublicensees in payment of the sublicense of the rights hereunder. The portion of the notes to be assigned in each year shall be determined in the first year of such sublicense, and shall be equal to the portion of such sublicensee's note delivered to [Mitchell] in the first year of such sublicense to the extent that it is nonrecourse (i.e., if the sublicensee is a limited partnership to the extent of the portion of the note that is not assumed by the limited partners).

Under section 6.2 of the license agreement, Tround agreed to apply all cash receipts from Mitchell solely and

exclusively for the development of open chamber drills and triangular rounds until Tround produced and completed the production engineering for a production-quality prototype open chamber drill and triangular rounds. Under section 6.3 of the license agreement, in the event Tround did not develop one working prototype, not of production quality, of an open chamber drill and triangular rounds within nine months of its receipt of the $500,000 installment of the advance license fee, Mitchell could elect to itself develop a working prototype with the assistance of Tround. Under section 6.7 of the agreement, in the event Tround failed to manufacture or cause to be manufactured, one production quality open chamber drill and triangular rounds within any twelve-month period ended on or before December 31, 1984, Mitchell had the right to undertake the development of these items to production quality with the assistance of Tround.

Section 6.6 of the license agreement provided in part as follows:

> All sales or rentals of Open Chamber Drills by TRI [Tround] for Licensed Use in the United States and Canada, prior to the Termination Date, shall be at a per drill selling price of not less than $100,000 or at a rental reasonably based upon such minimum selling price, together with a royalty payable to TRI [Tround] by the purchaser or renter of such drill in an amount equal to not less than one percent of the selling price of any and all oil and gas recovered from wells which were sunk with the use of such drill. * * *

On April 20, 1982, section 6.6 of the license agreement was amended to require Mitchell, at Tround's request, to charge a higher rental or sales price in lieu of the 1-percent royalty provided for in section 6.6 of the agreement.

When the license agreement was entered into by Tround and Mitchell in November 1980, only a scale model of the Terra Drill existed. The license fee of $1,600,000 payable under the agreement by Mitchell to Tround was to be used to develop a prototype of the drill.

Mitchell sublicensed its rights to the Terra-Drill to the six limited partnerships herein involved. The duration of each sublicense agreement was for a term of five years. Pursuant to the sublicense agreements, the fees for the sublicenses were payable partly in cash and partly by notes. The fees were designated on an annual basis. Pursuant to its sublicense agreement with Mitchell dated December 31, 1980, GSLDA was obligated to pay a portion of the sublicense fee in cash of approximately $1,000,000 in each of the first three years and, in addition, GSLDA executed notes payable to Mitchell dated December 31, 1980 ($10,103,440), October 1, 1981 ($7,643,472), October 1, 1982 ($7,650,432), October 1, 1983 ($8,700,000), and October 1, 1984 ($8,700,000). The due dates of the notes, June 15, 1993, were subsequently extended for an additional five years. Pursuant to its sublicense agreement with Mitchell dated December 31, 1980, RMDA, in its first three years, was obligated to pay annual license fees for each of the fiscal years commencing October 1, 1980, 1981, and 1982 of approximately $10,000,000, payable by notes to the extent of $8,412,212 in each of the first three fiscal years involved. Pursuant to its sublicense agreement with Mitchell dated December 31, 1980, FWDA in the first three years was obligated to pay annual license fees in each of the fiscal years commencing October 1, 1981, 1982, and 1983 in excess of $10,000,000, payable partially by note in each of the first three fiscal years involved in excess of $9,000,000. Pursuant to its sublicense agreement with Mitchell dated December 31, 1981, FWDA II, in the first three years, was obligated to pay annual license fees in each of the fiscal years commencing October 1, 1981, 1982, and 1983 of

approximately $5,000,000 payable by note in each of said fiscal years to the extent of $4,819,500, $4,087,650, and $4,087,650, respectively. Pursuant to its sublicense agreement with Mitchell dated October 30, 1981, MCDA, in the first three years, was obligated to pay annual license fees of $3,250,000 in each of the fiscal years commencing November 1, 1981, 1982, and 1983, partially payable by note in each of said fiscal years in the amount of $3,250,000. Pursuant to its sublicense agreement with Mitchell dated December 31, 1981, MCDA II, in the first three years, was obligated to pay annual license fees in each of the fiscal years commencing October 1, 1982, 1983, and 1984 of approximately $8,000,000, partially payable by note in each of said fiscal year in the amount of $7,318,500, $6,997,200 and $6,997,200, respectively.

The aggregate of the sublicense fee obligations of the six limited partnerships here involved to Mitchell under the five-year sublicense agreements was approximately $225,000,000. No orders were taken by the six limited partnerships for the Terra-Drill at any time.

The November 18, 1980, offering memorandum of GSLDA stated that the partnership was formed to engage in three different oil and gas related businesses: (1) a development drilling program in Ohio, (2) exploratory drilling in the Overthrust Belt in Utah and Colorado, and (3) the acquisition of an exclusive sublicense to use, sell and lease a new drilling product currently being developed, the Terra-Drill, in the western half of the States of Oklahoma and Alaska and for exploratory drilling on its exploratory property located in the Overthrust Belt in Utah and Colorado. The partnership planned to offer 280 units at $150,000 per unit, with each investor obligated to pay $12,500 on subscription and the balance evidenced by three 7-percent promissory notes, one in the amount of $12,500 payable March 1, 1981, the second in the amount of $12,500 payable

on March 1, 1982, and the third in the amount of $112,500 payable on January 15, 1993. The offering memorandum set forth the anticipated tax losses to be incurred by each limited partner during the first three years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1980	$12,500	($50,000)	400 percent
1981	12,500	($50,000)	400 percent
1982	12,500	($50,000)	400 percent

The private offering memorandum and promotional brochure for the GSLDA limited partnership represented that the partnership would drill 42 development wells on the Sheets Run Tract in Washington County, Ohio. The tract was located in southeastern Ohio. The GSLDA promotional brochure projected reserves of 16,800 barrels of oil per well over eight years and also projected net revenues of $201,358,533.

The November 18, 1980, RMDA offering memorandum stated that the partnership was formed to engage in (1) a development drilling program in Ohio, (2) exploratory drilling in the Overthrust Belt in Utah, and (3) the acquisition of an exclusive license to use, sell, and lease a new drilling product currently being developed, the Terra-Drill, in east and west Texas and for exploratory drilling on exploratory property in Utah. The partnership planned to offer 560 units at $150,000 per unit. The method of payment by the investor for each unit was similar to that in the GSLDA partnership. The offering memorandum set forth the anticipated tax losses to be incurred by each limited partner in the first three years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1980	$12,500	($50,000)	400 percent
1981	12,500	($50,000)	400 percent
1982	12,500	($50,000)	400 percent

The private offering memorandum and promotional brochure for the RMDA limited partnership represented that the partnership drill 53 wells in the Berea Formation and four wells in the Medina Formation in Morgan County, Ohio. The RMDA promotional brochure projected net revenue of $378,767,809 through 1996 based on reserves of 43,424 barrels of oil per Medina well and 9,522 barrels of oil and 119,800 MCF of gas per Berea well.

The May 11, 1981, FWDA offering memorandum for its 1981 oil and gas program stated that the partnership was formed to engage in (1) a development drilling program in Ohio, (2) exploratory drilling in Utah, and (3) the acquisition of a license to use, sell or lease a new drilling product currently being developed, the Terra-Drill, in central and east Texas and on its exploratory property in Utah. The partnership planned to offer 220 units at $157,500 per unit, with each investor obligated to pay $15,000 on subscription and the balance evidenced by three eight percent promissory notes, one in the amount of $15,000 payable on March 1, 1982, the second in the amount of $15,000 payable one March 1, 1983, and the third payable on January 15, 1994, in the amount of $112,500. The offering memorandum set forth the anticipated tax losses to be incurred by each investing partner during the first three years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1981	$15,000	($52,500)	350 percent
1982	15,000	($52,500)	350 percent
1983	15,000	($52,500)	350 percent

The private offering memorandum and promotional brochure for the FWDA limited partnership represented that the partnership would drill some 27 wells by December 31, 1983, in the same Berea Formation and Medina Formation (in Morgan County, Ohio) as RMDA. FWDA proposed to allocate a maximum of $3,960,000 over three years for the

drilling program in Ohio. FWDA also budgeted $175,000 for exploratory drilling in Utah. The promotional brochure cited the same figures for projected reserves as those used in the RMDA promotional brochure.

The December 1, 1981, FWDA II offering memorandum stated that the partnership was formed to engage in (1) a development drilling program in Tennessee and Oklahoma, (2) an exploratory drilling program in the Overthrust Belt in Utah, and (3) the acquisition of a sublicense to sell, lease, sublicense, or otherwise utilize a new drilling product currently being developed, the Terra-Drill, in California, Louisiana, Ohio, and Utah and to use the product on its own exploratory property. The partnership planned to offer 334 units at $150,000 per unit, with each investor obligated to pay $10,000 on subscription and the balance divided among three 8-percent promissory notes, one in the amount of $10,000 payable on March 1, 1982, the second in the amount of $10,000 payable on March 1, 1983, and the third in the amount of $120,000 payable on January 15, 1994. The offering memorandum set forth the anticipated tax losses to be incurred by each investing partner during the first three years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1981	$10,000	($40,000)	400 percent
1982	10,000	($40,000)	400 percent
1983	10,000	($40,000)	400 percent

The private offering memorandum and promotional brochure represented that the partnership would allocate a maximum of $3,707,400 over a 3-year period to drill development wells or leases in the Fort Payne-Mounteagle Formation in Tennessee and in the Northeast Sparks Prospect, Lincoln County, Oklahoma. The promotional brochure projected net revenues from the development drilling program in the amount of $174,656,773 based on the following

assumptions: each well in the Northeast Sparks Prospect would produce 100,000 MCF of gas and 61,425 barrels of oil over a 20-year life; (2) each Tennessee well would produce 100,000 MCF of gas and 35,000 barrels of oil over a 15-year life; and (3) escalation of oil prices at 11 percent per year and gas prices at 14 percent per year over a period of years.

The January 31, 1981, offering memorandum of MCDA stated that the partnership was formed to engage in (1) a development drilling program in Kansas and Oklahoma, (2) exploratory drilling in the Overthrust Belt in Utah, and (3) the acquisition of an exclusive sublicense to use, sell, and lease a new drilling product currently being developed, the Terra-Drill, in the State of Alaska and for exploratory drilling on its own exploration property in Utah. The partnership planned to offer 100 units at $150,000 per unit, with each investor obligated to pay $12,500 on subscription and the balance evidenced by four 8-percent promissory notes, one in the amount of $12,500 payable on March 1, 1982, the second in the amount of $12,500 payable on March 1, 1983, the third in the amount of $12,500 payable on March 1, 1984, and the forth in the amount of $100,000 payable on January 15, 1994. The offering memorandum set forth the anticipated tax losses to be incurred by each investing partner during the first four years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1981	$12,500	($37,500)	300 percent
1982	12,500	($37,500)	300 percent
1983	12,500	($37,500)	300 percent
1984	12,500	($37,500)	300 percent

The private offering memorandum and promotional brochure for the MCDA limited partnership represented that the partnership would acquire a 100-percent working interest in a 46-well development program in the New Albany Field area, Wilson County, Kansas. The promotional bro-

chure projected future net earnings from the developmental oil and gas program of $173,372,910, representing a gross return on the initial $2,000,000 allocated to the drilling programs of about 86-to-1. Intense drilling activity has been carried on in this area since the early 1900's. After drilling two dry wells, MCDA did not engage in any further drilling activity in Kansas. MCDA also participated in developmental drilling in the Sacatosa Field prospect and in White County and Morgan County, Tennessee.

The October 26, 1981, offering memorandum of MCDA II stated the partnership was formed to engage in (1) a development drilling program in Tennessee and Oklahoma, (2) exploratory drilling in the Overthrust Belt in Utah, and (3) the acquisition of an exclusive sublicense to use, sell, and lease a new drilling product currently being developed, the Terra-Drill, in Kansas and north and west Texas and for exploratory drilling on its own exploration property. The partnership planned to offer 334 units at $150,000 per unit with each investor obligated to pay $10,000 on subscription and the balance evidenced by three 8-percent promissory notes, one in the amount of $10,000 payable on March 1, 1982, the second in the amount of $10,000 payable on March 1, 1983, and the third in the amount of $120,000 payable on January 15, 1994. The offering memorandum set forth the anticipated tax losses to be incurred by each investor in the first three years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1981	$10,000	($40,000)	400 percent
1982	10,000	($40,000)	400 percent
1983	10,000	($40,000)	400 percent

The private offering memorandum and promotional brochure for the MCDA II limited partnership represented that the partnership would participate in developmental wells at

a fixed cost of $3,707,400. The proposed wells were to be drilled on leases in Tennessee and Lincoln County, Oklahoma. The MCDA II promotional brochure projected future net revenues from the developmental drilling program through 1995 in the amount of $193,775,028. The projection was based on reserve estimates of 57,800 barrels of oil and 544,000 MCF of gas for each Oklahoma well and 35,000 barrels of oil and 160,200 MCF of gas for each Tennessee well.

Each of the limited partnerships represented in its private offering memorandum that it would participate in exploratory drilling in an area of hard rock property in the Overthrust Belt in Utah. Each partnership budgeted $175,000 to conduct the exploratory drilling. No drilling was ever conducted by any of the partnerships on the leases in the Utah Overthrust Belt.

The portions of the sublicense fees payable by note by the limited partnerships to Mitchell were designated as partially recourse and partially nonrecourse pursuant to a formula in the sublicense agreements. The nonrecourse portion of the notes was in turn assigned by Mitchell to Tround. The total amount of nonrecourse notes assigned by Mitchell to Tround for all the years covered by the sublicense agreements was $35,188,384.

The promotional brochure for the limited partnerships contained projected oil production revenues and cash flow for the years involved. Generally, the projections covered the period from the date of the offering of the partnership units to approximately 1995. The oil and gas projections in the brochures assumed a reinvestment of 50 percent of the proceeds generated by the oil and gas drilling programs. The brochures also represented that cash flow was anticipated to be sufficient to repay the long-term notes prior to their stated due dates. The GSLDA promotional brochure stated that in the event the long-term notes had not been fully paid

prior to the due date, the general partners were authorized to borrow against reserves to prepay the note. The borrowing would be nonrecourse and the funds applied would fully discharge the investor's obligation on his long-term note. The promotional brochure further represented that only in the event the partnership cash flow was insufficient to pay the note, and only in the event that the partnership's proven reserves were insufficient to permit the partnership to borrow enough to pay the long-term note, would an investor be required to personally pay the note. The brochure noted that it was only the principal of the note an investor would have to pay since the interest on the long-term note was nonrecourse. Similar representations were made with respect to all of the limited partnerships here involved.

In November 1980, when the license agreement was entered into by Tround and Mitchell, the Terra-Drill was not in existence. Only the design concept existed. Among the complex design problems that confronted Tround, the development of a workable mud valve posed the greatest technical challenge. The technical difficulty in developing the mud valve was attributable in part to the requirement that the mud valve was allowed only 125-150/1,000,000 of a second to open and allow a projectile to exit from the gun barrel and then close to prevent drilling mud from flowing into the firing mechanism. After prolonged testing of the gun mechanism, the entire system was integrated with a drilling rig in or about January 1982, when the first actual drilling test was conducted at shallow depths with the Terra-Drill prototype. Tround conducted a series of tests in limestone and hard rock formations during 1982.

On May 14, 1982, Tround filed a prospectus with respect to a public offering of its stock. The prospectus stated that the securities were considered by Tround to be "highly speculative in nature and involve a high degree of risk." Tround anticipated the amount to be raised from the offer-

ing was $2,750,000. However, only about $1,600,000 was actually realized. As of December 31, 1982, the Tround technology known collectively as the open chamber system had yet to be successfully commercially exploited. In 1983 Tround built two additional prototypes, a 9⅞-inch drill and a 15-inch drill, incorporating changes based on the tests. In 1984 the 9⅞-inch drill was tested to about 1300 feet and in 1985 it was used in an actual gas well test. Tround continued its unsuccessful efforts to develop the mud valve in 1985 and to a limited extent in 1986. A functional Terra-Drill for hard rock drilling was never developed.

GSLDA entered into a turnkey drilling contract dated January 26, 1981, with Williston Drilling, Inc., for the drilling of 28 wells on the Archer's Fork and Sheets Run Tracts in Washington County, Ohio. GSLDA entered into a drilling agreement with Oklahoma Drilling Corp. on June 2, 1982, with respect to the Colona Prospect, Woodruff County, Arkansas. GSLDA received assignments of oil and gas leases from Williston Oil Corporation dated July 2, 1981, with respect to five leases in Washington County, Ohio. GSLDA received a partial assignment of an oil and gas lease from Omega Minerals, Inc., dated November 23, 1982, with respect to the Hoelscher Lease in Runnels County, Texas. GSLDA received assignments of oil and gas leases from Shah Oil Co., Inc., dated June 24, 1982, of a 37½-percent net revenue working interest in two 20-acre tracts in Young County, Texas. GSLDA received an assignment of an oil and gas lease dated August 26, 1981, from Williston Oil Corporation with respect to the Lyder Lease in Miami County, Kansas.

GSLDA drilled four wells in Washington County, Ohio. Two of the wells were drilled to 2,600 feet and two wells were drilled to 4,000 feet. Three of the four wells came in and produced oil and gas for some time. GSLDA drilled one well in 1984 in central Ohio which is still producing.

GSLDA took partial interests in other prospects together with the other partnerships and drilling was performed on each of these. GSLDA filed timely partnership returns for the taxable years 1980, 1981 and 1982. Each of the returns showed a net operating loss resulting from the partnership activities. The losses claimed in each of said years by GSLDA included deductions for sublicense fees paid to Mitchell.

During the period here involved RMDA drilled oil and/or gas wells on each of the following leases in Ohio: Spencer, Scott, County Infirmary, Harkins, Boll, Bebout, Adkins, Wood, Strode, and Ward. RMDA entered into a drilling contract with O'Neal Petroleum, Inc., dated December 14, 1981, with respect to six wells on various leases in Morgan County, Ohio. By letter dated May 4, 1982, RMDA authorized the use of completion funds for another prospect (Jutte #2) in Morgan County, Ohio. In 1982 RMDA entered into drilling agreements with O'Neal Petroleum, Inc., with respect to a prospect in Illinois and a prospect in Ohio. In 1981 RMDA entered into a turnkey drilling contract with O'Neal Petroleum, Inc., for the drilling of 20 wells on various leases in Morgan County, Ohio. In 1981 RMDA also entered into a turnkey drilling contract with O'Neal Petroleum, Inc., with respect to nine additional leases located in Morgan County, Ohio. RMDA drilled a well on the Meyer #1 lease and received drilling and production reports with respect to said well from the Oklahoma Drilling Company in 1982 and 1983.

David Harmon, a geologist with some 35 years of activity in the oil and gas business primarily in Ohio, was the vice president for exploration for O'Neal Petroleum, Inc., at the time RMDA embarked on its oil and gas drilling program. Mr. Harmon was involved in the determination with respect to drilling in the Berea Formation in Windsor Township, Ohio for both RMDA and FWDA.

RMDA timely filed partnership returns for taxable years 1980, 1981 and 1982. Each of the returns reflected a net operating loss from the partnership activities. The losses claimed by RMDA for each of the taxable years 1980, 1981 and 1982 included deductions claimed by RMDA for sublicense fees paid to Mitchell.

FWDA entered into a turnkey drilling contract dated January 1, 1982, with O'Neal Petroleum, Inc., to drill 10 wells on ten separate leases in Ohio and on December 30, 1982, entered into an additional turnkey drilling contract with O'Neal Petroleum, Inc., to drill five additional wells on five separate leases in Morgan County, Ohio. In July 1982, FWDA entered into (1) a drilling contract with O'Neal Petroleum, Inc., to drill ten wells on a lease located in Jefferson County, Ohio and (2) a drilling contract with O'Neal Petroleum, Inc., to drill a well or a lease in Richmond County, Illinois. On June 17, 1983, FWDA entered into a turnkey drilling contract with O'Neal Petroleum, Inc., with respect to five wells on separate leases located in Morgan County, Ohio, and on January 24, 1984, received from O'Neal Petroleum Inc., four assignments of 20-percent working interests in four of the aforementioned leases in Morgan County, Ohio. In March 1986, FWDA entered into a prospect agreement with Diversified Operating Corporation with respect to the Stuarco Reentry Prospect in Weld County, Colorado.

FWDA filed its partnership returns for the taxable year 1981 which reflected a net operating loss for said year. The net operating loss included a deduction for sublicense fees paid to Mitchell.

In 1982 FWDA II entered into a drilling contract and an operating agreement with Oklahoma Drilling Corporation with respect to (1) the Simpson Prospect in Garfield County, Oklahoma; (2) the Batson Prospect, Cooper No. 1 in Johnson County, Arkansas; and (3) the Sooner Trend

Prospect, Hare No. 1 in Garfield County, Oklahoma. FWDA II held an interest in a well known as the Webb No. 1 Prospect in Taylor County, Texas, effective October 10, 1983, and also held an interest in an oil and gas well known as the Allen No. 1 Prospect in Taylor County, Texas, effective December 14, 1983. FWDA II also held interests in eight wells located in Cumberland County, Tennessee pursuant to an operating agreement dated October 11, 1984.

FWDA II filed its partnership returns for the taxable years 1981 and 1982 and reported net operating losses in both taxable years. The losses claimed by FWDA II for both taxable years included deductions claimed for sublicense fees paid to Mitchell.

MCDA entered into a drilling contract in 1982 with Oklahoma Drilling Corporation with respect to the Simpson Prospect in Garfield, Oklahoma, a drilling contract and operating agreement with Oklahoma Drilling Corporation with respect to the Batson Prospect, Cooper No. 1 in Johnson County, Arkansas, a drilling contract and operating agreement with Oklahoma Drilling Corporation with respect to the Sooner Trend Prospect, Hare No. 1 in Garfield County, Oklahoma, and a drilling contract and operating agreement with Kansas Energy Corporation with respect to the Hazel West Prospect in Stafford County, Kansas. In 1983 and 1984 MCDA held working interests in oil and gas in two wells in Taylor County, Texas, and an oil and gas well in McClain County, Oklahoma. MCDA also acquired an interest in the Colona Prospect in Arkansas from Exxon Petroleum Corporation which turned out to be a dry well.

MCDA timely filed partnership returns for the taxable year 1981. MCDA reported a net operating loss for said taxable year which included a deduction claimed by MCDA for sublicense fees paid to Mitchell.

In 1982 MCDA II entered into a drilling contract and operating agreement with Oklahoma Drilling Corporation with respect to (1) the Simpson Prospect in Garfield County, Oklahoma, (2) the Batson Prospect in Johnson County, Arkansas, (3) the Sooner Trend Prospect, Hare No. 1 in Garfield County, Oklahoma, and (4) the State School lease in Kay County, Oklahoma. The lease in Kay County, Oklahoma, was drilled by MCDA II to a depth of approximately 3,500 feet at a cost of about $200,000 with an estimated time of payout of four years. In 1982 MCDA II also entered into a drilling contract and operating agreement with Kansas Energy Corporation with respect to the Hazel West Prospect in Stafford County, Kansas. In 1983 MCDA II held an interest in an oil and gas well known as the Webb No. 1 Prospect in Taylor County, Texas, and an interest in an oil and gas well known as the Allen No. 1 Prospect in Taylor County, Texas.

MCDA II timely filed partnership returns for the taxable years 1981 and 1982 and reported net operating losses for both years. The net operating losses included the deductions claimed by MCDA II for sublicense fees paid to Mitchell.

OPINION

Respondent disallowed deductions claimed by petitioners for their respective pro-rata shares of the losses generated by the six limited partnerships here involved: GSLDA, RMDA, FWDA, FWDA II, MCDA and MCDA II. Each of the limited partnerships was formed with the stated purpose of engaging in three different oil and gas related businesses: (1) a development drilling program in designated regions, (2) exploratory drilling in the Overthrust Belt in Utah and Colorado, and (3) the acquisition of an exclusive sublicense to use, sell, and lease a new drilling product, the Terra-Drill, in designated territories. The losses generated by the limited partnerships are represented in large part

by the sublicense fees purportedly incurred in the acquisition of the Terra-Drill sublicenses. The losses also included the partnerships' costs incurred with respect to their respective oil and gas programs. As grounds for the disallowance of the claimed losses, respondent asserts that neither the Terra-Drill sublicense programs nor the oil and gas drilling programs were activities entered into for profit within the meaning of section 183. Respondent also makes certain alternative arguments in support of his determinations.

Initially, we dispose of petitioners' contention that with respect to the oil and gas drilling activities of the limited partnerships, respondent has the burden of proof. We disagree with petitioners. In the statutory notice of deficiency sent to petitioners all of the claimed losses arising from their respective partnership activities were disallowed in full. Moreover, the petitions and answers filed in these cases squarely raise the issue of whether or not all of the transactions of the respective partnerships were entered into for profit. It is clear from the record that petitioners were fully aware of this aspect of the issues which they needed to confront. Consequently, we see no reason to depart in this instance from the general rule that the burden of proof is on petitioners. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).

At the trial, Exhibits UE and UF were admitted into evidence over petitioners' objections and the Court directed the parties to address the question of the admissibility of the two exhibits on brief. We have considered the arguments presented on brief as well as the circumstances surrounding the two exhibits. Both exhibits are letters signed by Mr. Herman Finesod and relate to investors in RMDA. Both letters, in essence, indicate a readiness to release an investor from any unpaid recourse obligations upon the investor's transfer of his partnership interest to Mitchell Petroleum Technology Corp. Petitioners' counsel was ap-

prised of one of the two letters at a stipulation of facts conference with respondent's counsel about a month prior to the commencement of trial. The second letter, which reflects in large part the factual content of the letter previously made available to petitioners' counsel, was first obtained by respondent's counsel some four days prior to commencement of trial and was also made available at that time to petitioners' counsel. Under these circumstances, we find no merit in the contentions of petitioners' counsel that the documents were not supplied to him in timely fashion. We adhere to our ruling at the trial admitting exhibits UE and UF in evidence.

Whether or not the activities in question were engaged in for profit must be determined at the partnership level. *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984). In view of the genesis and the strikingly similar structures and avowed programs of the six limited partnerships herein involved, our discussion and the conclusions reached equally applicable to all under section 183 will be conclusive with respect to each of the limited partnerships. Whether a partnership engages in an activity for profit turns on whether the partnership entered into or carried on the activity with an actual and honest objective of making a profit. *Dreicer v. Commissioner*, 78 T.C. 642, 644-645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). The expectation of making a profit need not be a reasonable one; it is sufficient if the objective of making a profit is bona fide. *Fox v. Commissioner*, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Zemel v. Commissioner*, 734 F.2d 9 (3d Cir. 1984), *Rosenblatt v. Commissioner*, 734 F.2d 7 (3d Cir. 1984), *Kratsa v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), *Leffel v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), *Hook v. Commissioner*, 734 F.2d 5 (3d Cir. 1984). In this context,

"profit" means economic profit, exclusive of tax savings. *Beck v. Commissioner*, 85 T.C. 557, 570 (1985); *Herrick v. Commissioner*, 85 T.C. 237, 255 (1985).

In determining whether an activity is engaged in for profit, we consider a nonexclusive list of some nine relevant factors contained in section 1.183-2(b), Income Tax Regs. These factors are: (1) The manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayers or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which were earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Not all of the factors are applicable or appropriate for every case, *Abramson v. Commissioner*, 86 T.C. 360, 371 (1986). No single factor is determinative; rather, the issue is one of fact to be resolved by examining all of the circumstances. *Waddell v. Commissioner*, 86 T.C. 848, 891 (1986), affd. 841 F.2d 264 (9th Cir. 1988). Greater weight is given to objective facts rather than to the parties' mere statements of their intent. Sec. 1.183-2(a), Income Tax Regs.; *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979).

Although each of the partnerships was formed with the stated purpose of engaging in three activities, the acquisition of a sublicense to market the Terra-Drill in designated territory, the development drilling program in specified areas, and the exploratory drilling program in the so-called Overthrust Belt in Utah, no exploratory drilling was ever conducted by any of the partnerships in the Overthrust Belt. We, therefore, turn to an examination of the economic validity of the remaining two activities described in the offering memorandum of each partnership.

Herman Finesod is sole stockholder of M&J Holding Company (M&J) which holds the stock of various corporations including Jackie Fine Arts, Hambrose Leasing, Hambrose Stamps, Worldco Services Group, Petro-Tech, Mitchell Energy and Mitchell Petroleum Technology Corporation (Mitchell). Mr. Finesod is president of the aforementioned corporations. James Haber, a certified public accountant, was secretary-treasurer of Mitchell. In 1979 Mr. Finesod began to consider the formation of limited partnerships as vehicles for oil and gas programs combined with new forms of technology. In 1980 Mr. Finesod became interested in a new technology, the Terra-Drill, being developed by Tround International Inc. (Tround).

Tround was incorporated in 1973 for the purpose of developing certain ordinance or gun technology called the open chamber system. The basic mechanism of an open chamber gun is a rotating gun cylinder with recesses cut in the side to accommodate the ammunition. Tround undertook to adopt the open chamber system to the development of a deep-hole oil and gas drill assembly (the Terra-Drill) which would pre-fracture rock with high-velocity projectiles fired through triple gun barrels in advance of a modified conventional rotary drill bit, enabling the bit to penetrate through rock at a faster rate.

Mitchell was formed in July 1980, and a few months later, on November 11, 1980, Mitchell and Tround entered into a license agreement under which Mitchell acquired the exclusive right to use, lease, and sell the new technology, but only for the exploration and recovery of oil and gas in the United States and Canada with the exclusion of some portions of such territories in accordance with other terms of the license agreement. In 1980 and 1981 Mitchell paid an advance license fee to Tround in the total amount of $1,600,000. Mitchell thereafter sublicensed its rights in the Terra-Drill to nine different partnerships, six of which are herein in-

cluded. The aggregate of the sublicense fee obligations of the six partnerships to Mitchell under the five-year sublicense agreements was approximately $225,000,000.

In 1980 only a plastic model of the Terra-Drill was in existence. Mr. Steven Dardick, the Tround executive who was directly involved with the new technology, testified that in 1980 the Terra-Drill was still a paper concept. It was not until January 1982, that the first actual drilling test with a Terra-Drill prototype was conducted at shallow depths. Notwithstanding the absence of a functioning Terra-Drill in 1980 and 1981 the six partnerships entered into sublicense agreements with Mitchell to market the Terra-Drill and incurred obligations to make substantial fee payments annually. The terms of the sublicense agreements with the partnerships were all set beforehand by Mitchell. No real negotiations took place with the general partners for the six partnerships who had been selected by Mr. Finesod after discussions with Mr. Haber and a law firm. Mr. Haber was aware in 1980 of the serious technical difficulties facing the developer of the Terra-Drill. Among the complex design problems confronting Tround, the development of a workable mud-valve posed the greatest technical challenge. The mud-valve, which was allowed only a fraction of a second to open and allow a projectile to exit from the gun barrel and then close to prevent drilling mud from incapacitating the firing mechanism, was a crucial and indispensable element in the functioning of the Terra-Drill. Tround continued its unsuccessful effort to develop a workable mud-valve through 1985 and, to a limited extent, in 1986. A functioning Terra-Drill for hard-rock drilling was never developed and no orders were ever taken by the six partnerships with respect to the Terra-Drill.

John E. Heard testified as respondent's expert witness with respect to the technical aspects of the Terra-Drill. Mr. Heard is a petroleum engineer who has specialized in

drilling activities. He has engaged in his profession extensively in the United States and in several foreign countries over some 34 years and is thoroughly familiar with the unique problems encountered in all aspects of drilling operations. Mr. Heard identified three major technological obstacles to the effective development of the Terra Drill: (1) the mud valve; (2) the gas purge system and pressure problems; and (3) tool miniaturization. Mr. Heard considered the magnitude of the efforts of other drilling tool manufacturers to develop comparable technology as well as the report prepared by Dr. William C. Maurer in a technical review of the Terra-Drill dated October 21, 1980, in which Dr. Maurer advised Mitchell that the mud valve presented a difficult design job because of the high speed requirements and because of the high fluid pressures involved. Dr. Maurer also stated that it could take extensive testing and redesigning to develop a reliable mud valve. Mr. Heard also considered the Sandia Laboratories Report dated June 1976, which related the status of the progress of the program conducted by the Sandia Laboratories with respect to the Terra-Drill concept. The report cited the mud valve as being a questionable area of design that would require immediate prototype testing to establish feasibility. Mr. Heard concluded that Tround, with its lack of adequate funding and its lack of technical personnel with oil field experience, would never be able to develop a reliable mud valve.

We note that Tround was fully aware of these design difficulties in 1980 when the license agreement with Mitchell was executed. During negotiations, Tround informed Mitchell that it would require in the vicinity of $20,000,000 to develop a marketable Terra-Drill. Clearly, the payment of $1,600,000 by Mitchell to Tround was inadequate.

Mr. Heard also emphasized further crucial technical problems which remained unsolved in the development of a workable Terra-Drill. In view of the high pressures existing

in a deep-hole environment of oil and gas drilling, it was indispensable to the successful operation of the Terra-Drill gas mechanism to maintain an equilibrium between the gas pressure within the gun mechanism and the pressure outside the gun barrel. Failure to achieve such equilibrium would cause drilling mud to flood the barrels and gun mechanism. Moreover, it is necessary to find a method of purging the high pressure gases that build up within the gun barrels. Otherwise, the spent cartridges would be ejected back into the gun mechanism with great force, damaging or jamming the gun. It does not appear that Tround has solved this problem. Mr. Heard also stated that the serious problem of miniaturization also remained unsolved. Certain standards have been established in the oil and gas drilling industry, including the material strength and restricted diameter of the steel casing used in drilling wells to meet varying conditions of pressure and collapse resistance. Miniaturization of the Terra-Drill would be essential in order to meet the andardized requirements prevailing within the oil industry. It does not appear that Tround has solved this particular problem. Mr. Heard believed that the miniaturization problem had to be solved before the Terra-Drill could be used for deep well drilling.

Edwin C. Broun, Jr., testified as respondent's expert witness with respect to the rights obtained by the six partnerships under their respective sublicenses to market the Terra-Drill. Mr. Broun has a B.S. degree in petroleum engineering and has worked extensively in the oil and gas drilling industry over a period of some 41 years. He analyzed the license agreement and its terms between Mitchell and Tround against the background of oil industry practices and also analyzed the commercial acceptance, or lack of it, of sublicenses for oil industry technology. He indicated that the transaction in which Mitchell licensed a tool and a system that was not yet operable and then sublicense it to limited partnerships for substantial amounts was not justifiable. He

further indicated that sublicenses of technology were little used in the energy services industry. We adopt the conclusions reached by respondent's expert witnesses with respect to the Terra-Drill and to the absence of economic validity of the sublicensing transactions under the circumstances presented by the record.

We have considered the testimony and report of petitioners' expert witness, Richard Golob. Mr. Golob is managing director of World Information Systems, a marketing and consulting firm. Mr. Golob is engaged primarily in the field of market research and analysis. He examined existing reports and studies and concluded that the various estimates and projections made by the partnerships with respect to the Terra-Drill program seemed reasonable. We find limited value in Mr. Golob's report and the conclusions reached by him. In reaching his conclusions, Mr. Golob relied in large part on assumptions made by third parties. Mr. Golob lacked the technical background which would enable him to make an independent evaluation of the validity of these materials. Some of the key assumptions accepted by Mr. Golob, especially those dealing with the technological readiness of the Terra-Drill in 1980 and 1981, proved incorrect, which would seriously impair the validity of the conclusions reached by Mr. Golob. Moreover, his analysis and conclusions with respect to the projected cost savings resulting from the use of a Terra-Drill were significantly inflated in that they were based on the erroneous assumption that oil well drilling takes place only eight hours per day rather than 24 hours a day which is the normal practice in the industry. On this record, we place little reliance on the testimony and report of Mr. Golob.

The dominant role played by Mr. Finesod and Mr. Haber in the formation of the six partnerships in 1980 and 1981 and in the almost identical structuring of each of the partnerships makes it unnecessary to examine separately the

economic viability of the Terra-Drill activities purportedly undertaken by each partnership. We can find very little indication that any of the partnerships had an actual and honest objective of earning a profit through their respective acquisitions for unrealistically inflated fees of a sublicense for the rights to a drill which, in effect, was little more than an untried concept. The absence of any real negotiations between the partnerships and Mitchell, the unquestioning acceptance without diligent inquiries of the preset terms of the sublicense agreements, and the glaring disparity between the amount paid by Mitchell for the Terra-Drill license and the heavy obligations incurred by the partnerships for the sublicense do not support a finding of a profit objective. See *Helba v. Commissioner*, 87 T.C. 983, 1005-1007 (1986).

It also appears that the individuals purportedly in control of the partnerships' activities lacked the requisite experience or expertise in the area of oil and gas drilling systems. Samuel J. Simon, the initial general partner for GSLDA, RMDA, MCDA and MCDA II, was a certified public accountant by profession. Due to his lack of experience in this area, he was unable to determine whether the sublicense fees were reasonable or reflective of acceptable business practices in the oil and gas drill technology industries. Nor does it appear that Leslie P. Lagoni, the initial general partner for FWDA and FWDA II had any training or background in oil and gas drilling technology. Consequently, no meaningful investigation into the economic merits of the sublicense agreement was attempted. Failure to make such elementary inquiries and to obtain expert advice in a transaction of this magnitude is not consistent with ordinary sound business practice and may be regarded as evidence that the partnerships lacked a profit objective. *Herrick v. Commissioner*, 85 T.C. 237, 256 (1985).

We have considered the purported reliance placed by Mitchell on the reports prepared by MPI Marketing Re-

search, Inc., and the Gelb Consulting Group late in 1980 in determining the sublicensing fees and the licensing districts to be covered by each sublicense. As far as we can determine, both entities were market research firms whose expertise and involvement in the oil and gas industry remains unclear. There is nothing in the record to attest to the experience of these market research firms in the field of advanced oil and gas drilling technology. Moreover, an examination of these reports prepared late in 1980 indicates that due to the limited time available for their preparation, the firms simply collected existing information of drilling activity by area and then arranged the data to arrive at equal market potential by district. The record shows that the studies were based on misconceptions which greatly diminish the value of the conclusions drawn in the studies. For example, a basic misconception in the reports was an erroneous assumption as to the definition of hard-rock drilling as that term is understood in the oil and gas industry and drilling rates experienced in the industry. We note that a basic misconception permeating these reports is that the Terra-Drill is technologically feasible. Such basic misconceptions, since they are integral to the results reached in the reports, seriously diminish the worth of such reports.

It is evident from the record that little time or effort was devoted by any of the partnerships to the exploration of the rights obtained to market the Terra-Drill under the sublicense agreements. A marketable Terra-Drill never existed. In view of the pivotal role played by Mr. Finesod in the acquisition of the Terra-Drill license from Tround and in the formation of the partnerships to acquire sublicenses to market this technology, we think it is significant that Mitchell, which was controlled by Mr. Finesod, made no effort to assist Tround in the development of a working prototype of the Terra-Drill even though Mitchell could elect to do so under the November 11, 1980, license agreement with Tround. The inaction of the partnerships in the face of

mounting evidence that the Terra-Drill development programs was showing negligible progress does not comport with a profit objective. The partnerships did little more than execute their respective sublicense agreements and incur onerous sublicense fee obligations to Mitchell. The mere acquisition by the partnerships of the right to market the drill is not, standing alone and in the context of this case, persuasive evidence of a profit objective.

None of the general partners in the six partnerships here involved during the relevant period showed any success in similar fields. In fact, the general partners lacked any experience whatever in the area of oil and gas technology. Finally, in view of the fact that a marketable Terra-Drill was never developed, the activities of the partnerships with respect to the actual marketing of the technology to third parties were negligible. We conclude that the six partnerships here involved did not engage in the Terra-Drill sublicensing activity in the years involved with an actual and honest objective of making a profit.

We reach the same conclusion with respect to the oil and gas development drilling activities of the six partnerships during the years here at issue. Some of the considerations which point to a lack of profit objective apply with equal force here. Each of the six limited partnerships stated in its offering memorandum area promotional brochures that, in addition to the purported Terra-Drill program, it would engage in two other activities, a development drilling program and an exploratory drilling program. The exploratory drilling supposedly was to take place mainly in the so-called Overthrust Belt in Utah. As indicated earlier in this opinion, no exploration drilling was ever conducted by any of the partnerships in the Overthrust Belt. With respect to the development drilling program, each of the partnerships represented that such drilling would take place in proven oil and gas areas: GSLDA in Ohio; RMDA in Ohio; FWDA in

Ohio; FWDA II in Oklahoma and Tennessee; MCDA in Kansas and Oklahoma; and MCDA II in Tennessee and Oklahoma.

The manner in which each of the partnerships embarked upon and carried on its respective development drilling activities indicates the absence of a bona-fide objective to make a profit, exclusive of tax savings. Each of the partnerships in its promotional materials and offering memorandum outlined drilling programs replete with the numbers of wells to be drilled in proven oil and gas areas with projections of net earning in impressive amounts over a period of years. Such drilling programs were to a large extent consistently abandoned.

RMDA represented that it would drill 53 wells in the Berea Formation and four wells in the Medina Formation, both located in Ohio. The promotional brochure projected net revenue of $378,767,809 through 1996 based on 43,424 barrels of oil per Medina well and 9,522 barrels of oil and 119,800 MCF of gas per Berea well. Two Berea wells were drilled and subsequently shut in due to high water production and two other Berea wells were plugged and abandoned. The partnership then abandoned its drilling activity in these areas. Available geological data and State survey maps indicated the production capabilities of wells drilled in this area. Mr. Hobbs concluded that the proposed Berea locations were in an area known to be water productive and that no oil and gas resource should have been attributed to the Berea formation. The results of the four or five wells drilled for RMDA in the Berea formation confirmed this. Moreover, the projected output of Medina wells was based upon data which was unrepresentative of the area as a whole. RMDA subsequently turned to drilling prospects outside the State of Ohio. Other partnerships also participated in these same prospects. Mr. Hobbs examined these prospects, including the Sacatosa Field Prospect in Texas,

and the prospect in western Illinois. He concluded the Texas prospect was marginal and characterized by very low oil recovery and concomitant high operating costs. Mr. Hobbs considered oil production in western Illinois as highly erratic. He concluded that the interests acquired by RMDA in this area were very marginally productive. Mr. Hobbs reviewed all the additional drilling prospects selected by RMDA after it abandoned the original prospects in Ohio and concluded that the properties were marginal prospects in depleted areas and that all the so-called developmental properties had very poor reserve potential.

GSLDA represented that it would conduct a 42-well drilling program in southeastern Ohio, projected reserves of 16,800 barrels of oil per well over an 8-year period, and projected net revenues of $201,358,533 through 1995. The 42-well drilling program in southeastern Ohio was apparently abandoned after some four wells were drilled with unsatisfactory results. G. Warfield Hobbs, respondent's expert witness with respect to the partnership drilling activities, indicated that on the basis of geological data and the prior history of oil well drilling in the region, the cash flow projections and the estimated reserves for the purposed GSLDA wells were grossly misrepresented and highly inflated. Mr. Hobbs indicated that in this area of fairly marginal production the poor results realized by GSLDA could have been readily anticipated. GSLDA then turned to substitute properties and took partial interests in several States which included prospects in western Illinois, the Sacatosa Field in Texas, and a number of interests in wells in Tennessee.

GSLDA drilled wells in these prospects with varying results. Mr. Hobbs analyzed the underlying information and data with respect to each developmental project. Material was also obtained from State geological surveys. Each prospect was individually analyzed. It was concluded after a

full and careful investigation that the majority of the projects in which GSLDA participated had poor production potential and had no chance of ever approximating the ratio or returns in investment which were promised in the offering memorandum.

FWDA represented that it would drill 27 wells by December 31, 1983, in the same Berea and Medina formations in Ohio as RMDA. The same oil reserve figure used in the RMDA promotional material was also used with respect to FWDA. The FWDA promotional brochures projected net earning through 1996 in the amount of $165,201,580. FWDA did not engage in the drilling activities in Ohio as represented in the promotional material and in the private offering memorandum. It appears that FWDA subsequently acquired partial working interests in a number of wells to be drilled by O'Neal Petroleum, Inc., in Ohio. FWDA also turned to drilling prospects outside the State of Ohio and participated in the acquisition of interests in western Illinois, the Sacatosa Field in Texas, and a prospect in Colorado. The opinion of Mr. Hobbs, respondent's expert witness, with respect to the marginal nature of the wells at the Sacatosa field in Texas and the prospects in western Illinois, is equally applicable here. Mr. Hobbs concluded that the majority of the prospects in which FWDA participated have poor production potential and had little chance of ever providing substantial profits on drilling dollars invested. He also concluded that the representations made by the partnership sales brochure regarding potential reserves and future cash flow were highly exaggerated and that the purported returns on drilling investment were inflated and unrealistic.

FWDA II represented that it would allocate a maximum of $3,707,400 over a 3-year period to drill development wells on the Fort Payne-Mounteagle formations in Tennessee and in the Northeast Sparks prospect in Lincoln County, Oklahoma. The promotional brochure projected net reve-

nues from the development drilling program in the amount of $174,656,773. The Northeast Sparks Prospect in Oklahoma was never drilled. Mr. Hobbs examined the available geological information with respect to this area and concluded that the proposed partnership drilling was in a depleted zone and was basically worthless. Nor does it appear that the proposed drilling program in Tennessee was ever carried out by the partnership. The partnership substituted other prospects for drilling in Tennessee and also participated jointly with the other partnerships here involved in prospects in various states including the Sacatosa Field prospect in Texas and prospects in western Illinois. Mr. Hobbs concluded that the properties selected by FWDA II for its drilling activities, including the joint participation properties, were poor prospects and that the prospects, with their poor production potential, had little chance of generating the revenues proposed in the promotional materials.

MCDA represented that it would acquire a 100 percent working interest in a 46-well development program in the New Albany Field area in Wilson County, Kansas. The partnership projected net earnings from the development program in the amount of $173,372,910 through 1994. After drilling two dry wells, MCDA did not engage in any further drilling activity in Kansas. MCDA then acquired interests in other prospects in Texas, Oklahoma, Ohio, Arkansas and Tennessee. Many of these prospects, for example the Sacatosa Field in Texas, had participation by some of the partnerships herein involved. Mr. Hobbs analyzed the available data, including quarterly reports provided to the limited partners over this period, and concluded that the majority of the prospects in which MCDA participated had poor production potential.

MCDA II represented that it would participate in developmental wells at a fixed cost on leases in Tennessee and in

Lincoln County, Oklahoma. The partnership projected net earnings through 1995 from its developmental drilling program in the amount of $193,775,028. MCDA II never drilled wells in the prospect in Lincoln County, Oklahoma. Nor were any wells ever drilled by MCDA II in the Tennessee prospect as designated in the promotional materials. MCDA II substituted partial working interests in other prospects in Oklahoma, Tennessee, Texas, Arkansas, Ohio, and Kansas. A principal substitute property was in the Sacatosa Field in Texas. Mr. Hobbs examined the relevant reports and geological data and concluded that the majority of the prospects in which MCDA II participated had poor production potential.

Dr. Jaromir Ledecky is an economist with over 20 years experience in strategic planning and economic forecasting. His background includes oil company financial analysis experience including oil demand and price forecasting. From 1980 to 1982 he served as Director of U.S. Economic Analysis at CONOCO, Inc. Dr. Ledecky, as respondent's expert witness, prepared the portion of the expert witnesses' combined report pertaining to oil and gas price forecasts used by the six partnerships in their productional materials. In making his evaluation of such oil and gas price forecasts, Dr. Ledecky considered, inter alia, the economic conditions prevailing in the oil and gas industry during the period 1978 to 1982, oil and gas price forecasting methodologies, price forecasts made by the United States Department of Energy, and price forecasts used by petroleum engineering firms within the oil industry.

Each of the six partnerships made projections of its expected revenues from its oil and gas drilling operations. Future revenues were based on reserve volumes produced each year and the price received for oil and gas sold each year. In making the revenue projections, the partnerships escalated prices at a rate 11 percent from the initial year of

production to the final year of production. The reason for the 11 percent escalation rate is unexplained. The maximum price per barrel of oil used in their revenue projections by the partnerships was as follows:

Partnership	Terminal Year	Maximum Oil Price Per Barrel
GSLDA	1995	$153.08
RMDA	1996	169.92
FWDA	1996	169.92
FWDA II	1995	141.95
MCDA	1994	137.91
MCDA II	1995	141.95

Dr. Ledecky testified that the oil and gas prices used to project the future revenues of the partnerships were based on a methodology called "naive forecasting" which assumes that conditions which prevailed in the past will continue to prevail indefinitely in the future. Dr. Ledecky stated that the naive forecast methodology does not take into effect future trend changes or reversals and he indicated that the method was particularly inappropriate for forecasting long-term oil and gas prices because of the historical sharp price changes and trends. He testified that the results of naive forecasting depended on the selection of a particular trend. Dr. Ledecky indicated that the partnerships, in making their revenue projections on the basis of the trend of oil prices during the short 1979 - 1981 period which Dr. Ledecky regarded as a brief period of maximum price escalations, produced a series of revenue projections that were unrealistically high. In effect, a cyclical price movement was extended by the partnerships into a trend covering the decade of the 1980's and half of the 1990's decade. He indicated that in view of the weak demand for oil and gas in 1980 and 1981, coupled with a sharp increase in supply, the use of the naive forecasting method based on the oil price of this brief period and the use of a constant 11 percent escalation factor did not yield reasonable results. It was concluded in the expert witness report that the oil price forecasts made by the

partnerships were unreasonable and not consistent with practices within the petroleum industry.

In short, the record underscores a propensity on the part of each of the partnerships to select or acquiesce in drilling prospects that were only marginally productive, both with respect to the properties designated in the original drilling programs and in the substituted properties. In view of the drilling data and geological information readily available to the industry in 1980, the uniformly unsuccessful results encountered by the partnerships in their original drilling programs were fairly predictable. We regard this seeming indifference to available information in conducting the partnership activities as evidence of the lack of a bona-fide profit objective in embarking upon these activities. Moreover, the projected revenues from the drilling program were based upon oil and gas reserves in the various prospects that were demonstrably unrepresentative of the past drilling histories in the prospects involved. Finally, the projected ratio of partnership returns to the cash budgeted by the partnerships for the development drilling programs was far beyond the normal returns historically experienced in the oil and gas industry. For example, the projected returns on investment in development drilling, assuming that all units in the partnerships were sold to investors, ranged from about 40-to-1 to a peak in excess of 80-to-1. In view of the evidence in the record which clearly shows that, in general, the ratio of returns to cash investments in this particular industry investments of considerably less than 10-to-1 are regarded as reasonable and within industry expectations, the portrayal of the contrived ratios in the promotional materials highlights the illusory nature and absence of economic substance in the development drilling activities of the partnerships.

Neither Mr. Simon, the individual general partner of four partnerships, nor Mr. Lagoni, the individual general partner

of the remaining two partnerships, had any significant experience or background in the development drilling reports of the oil and gas industry. The corporate general managers of the partnerships were actually engaged by the partnerships as drilling contractors whose compensation was in large part geared to the number of wells drilled rather than to the success of the wells. Since most of the original prospects designated by the partnerships for their development drilling programs were abandoned, it would not appear that the purported expertise of the corporate general partners could be considered an aid to the selection of promising properties with potentials for profit. While the corporate general partners did in some instances drill producing wells, there is scant evidence in the record to establish the profitability of the results achieved by the partnerships under the development drilling programs conducted in the substitute prospects. Respondent's expert witness concluded that, in view of the scope of the actual investment by the partnerships in their respective drilling programs and the poor production potentials of the prospects selected, it was unlikely that the drilling activities of the partnerships would ever generate sufficient revenues to net the overall obligations of the partnerships or generate profits on the investments made in the partnerships. We must conclude on the basis of the entire record that none of the partnerships here involved entered into the development drilling activities with an actual and honest objective of making a profit.

An examination of the activities of each partnership in its totality buttresses our conclusion with respect to the absence of a bona-fide profit objective. The huge disparity between the cost to Mitchell of $1,600,000 to acquire the Terra-Drill license from Tround in 1980 followed by the willingness of the partnerships unquestioningly to incur obligations of approximately $225,000,000 for territorial sublicenses for an untried technology does not indicate a profit-motivated concern. Moreover, in view of the complete absence of any

workable Terra-Drill which would enable the partnerships to generate revenues to meet their heavy obligations, the abandonment of the exploratory drilling program, the gradual abandonment of the prospects designated by the partnerships for their original development drilling programs and the stark unreality of the revenue projections from the drilling activities which were based upon untenable assumptions all reinforce a conclusion that the partnerships were indifferent to the success of the venture as a business proposition. The tax advantages offered by each of the six partnerships were prominently featured in the respective offering memoranda. For example, the offering memorandum of GSLDA set forth the anticipated tax losses to be incurred by each limited partner per unit of investment during the first three years as follows:

Year	Cash Investment	Estimated Tax Loss	Loss as a Percent of Cash Invested
1980	$12,500	($50,000)	400 percent
1981	12,500	(50,000)	400 percent
1982	12,500	(50,000)	400 percent

The identical 4-to-1 tax advantage was featured in the offering memoranda for RMDA, FWDA II and MCDA II; a 3½-to-1 tax advantage was offered by FWDA; and a 3-to-1 tax advantage was offered by MCDA. We are convinced that the concern of each of the six partnerships was to create the heralded tax advantages. We hold that the activities of each of the six partnerships here involved were not engaged with an actual and honest objective of making a profit within the meaning of section 183. The partnerships, therefore, are not entitled to the deductions claimed by them in the years here at issue except as otherwise allowed by section 183(b) and, accordingly, petitioners herein are not entitled to deductions for the distributive losses claimed by them in the years at issue. Our conclusion with respect to the absence of a profit objective is dispositive of the cases before us.

Because the partnerships' transactions were devoid of any profit objective, as we have concluded, and lacked economic substance, the deductions claimed by the accrual basis partnerships for interest on the note obligations pursuant to section 163(a) to Mitchell, which had no practical economic effect other than the creation of tax losses, must also be disallowed. *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054, 1067-1068 (1988). We are persuaded on this record that the note obligations did not reflect a genuine indebtedness from the partnerships to Mitchell. It is settled law that in order for an interest deduction to be allowable, the indebtedness must be genuine. *Herrick v. Commissioner*, 85 T.C. 237, 260 (1985).

With respect to the Terra-Drill programs of the partnerships, respondent makes an alternative argument that the deductions claimed for the sublicense fees should be disallowed for failure to meet the requirements for deductibility pursuant to section 1253(d)(2). The partnerships considered their sublicenses to be franchises and claimed annual deductions for their respective sublicense fees pursuant to section 1253(d)(2). Section 1253(d)(2) allows a deduction for payments (other than contingent payments within the meaning of section 1253(d)(1)) made by transferees of a franchise. In *Herrick v. Commissioner*, *supra* at 266, we concluded that in order for such amounts to be deductible under section 1253(d)(2), "the taxpayer must be operating or conducting a trade or business after the payments are made." We further stated that "The mere signing of an agreement for the transfer of a franchise or distributorship, and payment of the acquisition or initial fees, do not, ipso facto, entitle the taxpayer to a deduction." *Herrick v. Commissioner*, *supra* at 266. In *Jackson v. Commissioner*, 86 T.C. 492 (1986), affd. 864 F.2d 1521 (10th Cir. 1989), we again held that the trade or business requirement was a prerequisite to any deduction under section 1253(d)(2) and emphasized that merely acquiring a license to distribute a

product within a territory does not place the taxpayer in the trade or business of distributing that product.

Here, we have concluded that none of the partnerships engaged in any meaningful activity with respect to the Terra-Drill sublicense. In fact, the record clearly establishes that a working Terra-Drill did not even exist during the years at issue. Moreover, it appears that a working Terra-Drill still has never been developed. Finally, the record establishes the complete absence of a profit objective on the part of the six partnerships in their acquisition of their respective territorial sublicenses to market the nonexistent Terra-Drill. We conclude on this record that the partnerships were not in a trade or business with respect to the Terra-Drill program during the year at issue and therefore are not entitled to the claimed deductions in connection with the sublicense fees under the provisions of section 1253(d)(2).

Respondent in the notice of deficiency determined additions to tax under section 6653(a)(1) and (2) in the cases pertaining to petitioner Nicholas L. Arky and petitioners Lester H. Strickler and E. Grace Strickler. Petitioners have the burden of proof in these cases. *Bixby v. Commissioner*, 58 T.C. 757, 791-792 (1972). Respondent also claimed additions to tax under sections 6653(a) and 6653(a)(1) and (2) by amended answer in the remaining cases as indicated above. Respondent has the burden of proof where the issues were raised by amended answer. See Rule 142(a).

Sections 6653(a) and 6653(a)(1) impose an addition to tax if any part of an underpayment is due to negligence or disregard of rules and regulations. Section 6653(a)(2) imposes an addition to tax in the amount of 50 percent of the interest due on the portion of the underpayment attributable to negligence.

Negligence is defined as the lack of due care or failure to do what a reasonable and prudent person would do under the circumstances. *Neely v. Commissioner*, 85 T.C. 934, 937 (1985). The general rule is that the duty to file accurate returns cannot be avoided by placing responsibility on an agent. *Pritchett v. Commissioner*, 63 T.C. 149, 174 (1974). An exception to this rule may exist where the taxpayer, in preparing his return, relied on the advice of a competent tax adviser. See, e.g., *Industrial Valley Bank & Trust Co. v. Commissioner*, 66 T.C. 272, 283 (1976); *Woodbury v. Commissioner*, 49 T.C. 180 (1967). However, reliance on professional advice does not, by itself, constitute an absolute defense to negligence but, rather, it is a factor to be considered. *Freytag v. Commissioner*, 89 T.C. 849, 888 (1987), affd. 904 F.2d 1011 (5th Cir. 1990). The taxpayer's reliance must be in good faith and demonstrably reasonable. *Ewing v. Commissioner*, 91 T.C. 396, 423 (1988); *Freytag v. Commissioner, supra* at 888-889.

Petitioner Nicholas L. Arky and petitioners Lester H. Strickler and E. Grace Strickler did not testify at the trial of this consolidated group of cases. Petitioners in these two cases have the burden of proof. *Bixby v. Commissioner*, 58 T.C. 757, 791-792 (1972). Mr. Arky acquired his interest in MCDA II in 1981. He made a cash down payment of $10,000 and executed two negotiable promissory notes due March 1, 1982, and March 1, 1983, respectively, each in the amount of $10,000. He also arranged an open account obligation payable to MCDA II in the amount of $120,000 payable in 1994. He claimed losses on his 1981 and 1982 Federal income tax returns in the respective amounts of $39,600 and $42,967 with respect to his investment in MCDA II. Mr. Strickler acquired his interest in FWDA II in 1981. He too made a cash down payment of $10,000 and executed two promissory notes due March 1, 1982, and March 1, 1983, respectively, each in the amount of $10,000. He also arranged an open account obligation to FWDA II in

the amount of $120,000 payable in 1994. He claimed losses on his 1981 and 1982 tax returns in the respective amounts of $39,600 and $42,200 with respect to his investment in FWDA II. We have examined the nature of the proposed activities of MCDA II and FWDA II and we have concluded that neither of these partnerships engaged in profit oriented activities in the period involved. As stated above, none of the petitioners testified as to the circumstances surrounding their respective investments. Accordingly, in the absence of any persuasive evidence from said petitioners with respect to the negligence issue, we must sustain respondent.

Nor was there any testimony with respect to petitioners in docket No. 47752-86 (Estate of Aaron Bassin, Deceased, Ruth Bassin, Personal Representative, and Ruth Bassin). Mr. Bassin (now deceased) acquired an interest in MCDA in 1981. He made a cash down payment of $12,500 and executed three promissory notes due March 1, 1982, 1983 and 1984, respectively, each in the amount of $12,500. He also executed a nonnegotiable promissory note in the amount of $100,000 due January 15, 1994. On his 1981 Federal income tax return he claimed a loss of $37,104 with respect to his investment in MCDA. Respondent introduced evidence and expert witness testimony to establish the lack of any feasible profit potential in the proposed activities of MCDA as well as the remaining partnerships. We concluded on the basis of the record that the activities of MCDA were not engaged in for profit. The record also establishes that the lack of a bona-fide profit objective on the part of the partnership was evident at the very outset. The absence of economic reality in the partnership programs could, we believe, have been readily discovered with the exercise of a modicum of due care. On this record, we must sustain respondent's determination of negligence for the taxable year 1981.

Petitioner Rosco C. Webb, Jr., who has been a surgeon since the late 1950's, acquired his interest in FWDA in 1981. He testified that he learned about FWDA from his accountant and that he relied on his accountant in making the investment in FWDA. Dr. Webb made no effort to investigate the feasibility of his investment in FWDA and did not know whether his accountant had done so. Dr. Webb could recall little about his investment. He knew nothing about the Terra-Drill technology and had little or no knowledge of the partnership activities. Dr. Webb was unaware of any open account obligations to FWDA in the amount of $225,000 due in 1994. We do not believe that Dr. Webb, in view of his scant knowledge about the nature of his investment in FWDA, showed due care in failing to apprise himself of the economic merits of the proposed partnership program. We are not convinced that his perfunctory reliance on his accountant is tantamount to obtaining and relying upon expert advice. Under the circumstances, we do not believe that Dr. Webb's reliance on his accountant relieves him of his duty to file accurate returns. We conclude that petitioner Webb in this case was negligent.

Petitioner Fred J. Sherman is in the export trading business and is president and principal owner of Searock Trading Corporation. He acquired his interest in GSLDA in 1980 upon the recommendation of his accountant. Mr. Sherman testified that he could not recall seeing the GSLDA promotional material and further testified that he made no independent analysis of the value of his investment. Prior to 1980 he had not heard about the Terra-Drill and he knew that no drill had been developed at the time of his investment in GSLDA. Mr. Sherman also testified that he did not know about the subsequent progress made in the development of the Terra-Drill. Mr. Sherman, an experienced businessman, acquired his interest in GSLDA without any independent analysis of the venture. His reliance on his accountant, whose expertise in this area is not evident,

does not automatically absolve Mr. Sherman of negligence. Mr. Sherman acquired his interest in the partnership even though he knew the Terra-Drill, which was the centerpiece of the partnership endeavors, had not yet been developed. His initial lack of concern in the economic validity of the partnership enterprise as a whole is buttressed by his apparent indifference to the rate of progress, or lack of such progress, in the subsequent development of the Terra-Drill. If there had been a bona fide examination of the partnership programs, it is unlikely that any reasonable person would have expected such programs to work. See *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983), affg. a Memorandum Opinion of this Court. On this record, we conclude with respect to petitioner Sherman that the addition to tax for negligence for the year involved must be sustained.

Petitioner Quaiser Bakht has been a physician since 1955. Dr. Bakht acquired his interest in GSLDA in 1980. He learned about GSLDA from an individual who regularly came to petitioner's hospital to sell a variety of investments. Dr. Bakht testified that his accountant saw the proposal and purportedly advised him that it was risky but made sense in the long run. Dr. Bakht did not know about the Terra-Drill prior to 1980, and he mistakenly thought that GSLDA was not limited to marketing the drill to a specific territory but, rather, could market it worldwide. Dr. Bakht testified that he has never seen the drill and does not know whether or not it was in existence. He did not know where GSLDA proposed to conduct the exploratory drilling programs. Nor did he make any effort independently to obtain engineering or geology reports with respect to the feasibility of the exploratory drilling program. Dr. Bakht was not familiar with the development drilling program proposed by GSLDA, and he apparently did not read the offering memorandum concerning such programs. There is no indication that Dr. Bakht's accountant had the requisite market experi-

ence with respect to advanced drilling technology or the oil and gas industry upon which to base an opinion that Dr. Bakht reasonably and in good faith could rely upon. He apparently acquired his interest in GSLDA with little or no understanding of the nature of the proposed partnership programs. On this record, we conclude that petitioner Bakht is liable for the additions to tax for negligence for the year involved within the meaning of the statute.

Petitioner Michael Sirkus has a bachelor of arts degree from New York University and during the period here involved he was in the wholesale seafood business. Mr. Sirkus acquired his interest in RMDA in 1980 after learning about it from his accountant. Mr. Sirkus did not know about the Terra-Drill prior to 1980. He was not aware of any design problems concerning the Terra-Drill in 1980, he did not know that RMDA sublicensed the right to use and market the drill, and he could not recall the derivation or cause of the partnership losses in the first three years of its existence. Mr. Sirkus did not know what was involved in the proposed exploration drilling program of RMDA. Nor was he familiar with the GSLDA development drilling program. Mr. Sirkus made no independent effort to determine the feasibility of the various activities proposed by the partnership in which he invested. There is no showing that the accountant who told Mr. Sirkus about the RMDA venture had the requisite expertise to gauge the economic feasibility of the various programs proposed by RMDA. Mr. Sirkus' ready acquisition of an interest in RMDA notwithstanding his apparent lack of familiarity with the basic essentials of the RMDA venture and the absence of any efforts to investigate the bona fides of the program is not consistent with the actions of a reasonable and prudent investor. We must therefore conclude on this record that petitioner Sirkus in this case was negligent and hence liable for the additions to tax for negligence in the taxable year involved.

Petitioner William R. Parient, Jr., is a certified public accountant. At the time he acquired his interest in RMDA he was vice president and treasurer of a worldwide distributor of various products for the cable television industry. Mr. Parient acquired his interest in RMDA in 1980. He learned about RMDA through Worldco, a marketing entity for the RMDA program. Mr. Parient did not investigate the financial status of RMDA when he made his investment and he was unaware of its assets or liabilities. He had not heard about the Terra-Drill prior to 1980. Although he indicated that he was mostly interested in the potential of the Terra-Drill, rather than the exploration and development drilling program of RMDA, he could not recall whether a prototype of the drill ever existed in 1980. In fact, he could not recall what the partnership planned to do about the Terra-Drill in 1980. He did not know the status of the long-term notes that he executed when he acquired his interest in RMDA. He also testified that he might consider legal action to contest any efforts to collect on the long-term obligations when they came due some time in the late 1990's. In view of Mr. Parient's professional and business background, we find his actions in acquiring his RMDA interest without the normal prudent inquiries to be unreasonable. He obviously did not display the expected prudent concern about the economic viability of his investment. On this record, we must conclude that petitioner Parient in this case was negligent and therefore liable for the additions to tax for negligence in the taxable year involved.

Petitioner George Tsakonas is a medical doctor. Dr. Tsakonas acquired his interest in FWDA in 1981 after he learned about the partnership from materials he received in the mail. He testified that he discussed the investment with his tax return preparer. Dr. Tsakonas had no prior experience in the areas of drill bit technology or oil and gas. He was not familiar with the sublicense fee arrangement under which FWDA acquired its rights to the Terra-Drill

technology. When Dr. Tsakonas acquired his interest in FWDA in 1981 he was unaware of the stage of development of the Terra-Drill. He did not know the amount paid by FWDA to acquire its sublicense. Finally, Dr. Tsakonas testified that he was not aware of the difference between the exploratory drilling and the development drilling programs proposed by FWDA. Dr. Tsakonas' efforts to analyze the economic worth of his investment were practically nonexistent. His evident lack of concern about the bona fides of the partnership programs does not reflect the actions of a prudent and reasonable investor. On this record we find that petitioner Tsakonas in this case was negligent and therefore liable for the additions to tax for negligence in the taxable year involved.

Petitioner Eugene Pitts is a medical doctor, now retired. Dr. Pitts acquired his interest in FWDA II in 1982 but could not recall how he heard about the partnership. He has no background in oil and gas or in advanced tool technology. Dr. Pitts testified that he very vaguely knew what a drill bit was. He was not familiar with the structure of the partnership or with any of its proposed activities. Nor did he know if a Terra-Drill was in existence when he acquired his interest in FWDA II in 1982. There is no indication that he made any effort to investigate the nature of his investment. Finally, Dr. Pitts testified that he had no recollection about his long-term obligation to the partnership originally due in 1993 and subsequently extended to 1998. On this record we do not believe that Dr. Pitts' actions in perfunctorily embarking on this partnership venture comported with those of a prudent and reasonable person. We conclude that petitioner Pitts in this case was negligent and hence liable for the additions to tax for negligence in the taxable year involved.

Petitioner Frank Dietrich described his occupation as a business manager dealing with maintenance repair and up-

keep. He acquired his interest in MCDA in 1981 through his wholly owned small business corporation, SETO, Inc., Mr. Dietrich was not sure about the nature of the corporation's business activities other than the acquisition of the MCDA interest. Petitioner learned about MCDA from one Ron Gould. Petitioner stated that Mr. Gould was "some kind of a broker, I guess." Mr. Dietrich testified that he skimmed through the MCDA promotional material. He did not know whether a prototype of the Terra-Drill existed in 1981. Nor did he know of any existing technical problems with respect to the drill in 1981. He did not know where the Overthrust Belt was located and he did not know whether MCDA ever conducted any drilling operations there. Mr. Dietrich did not know the amount paid by MCDA to acquire its rights under the sublicense. Finally, Mr. Dietrich made no effort to obtain an independent evaluation and analysis of the explanation and development drilling programs. We do not believe that the stark indifference displayed by Mr. Dietrich to the bona fides and to the economic validity of the partnership venture comports with the actions of a prudent and reasonable investor. On this record, we conclude that petitioner Dietrich in this case was negligent and therefore liable for the additions to tax for negligence for the taxable year involved.

Petitioner Herman David has been in the diamond business since the late 1940's. He could not recall anything about MCDA II. Mr. David who claimed a loss of $64,451 on his 1982 return with respect to the MCDA II investment, testified that his sons made his investments. Mr. David's son, Sheldon, also testified. Mr. Sheldon David has an M.A. in business administration and, together with his brother, has been in full control of his father's business for some ten years. Mr. Sheldon David has no experience in drill bit technology or in the area of oil and gas. He learned about MCDA II through his accountant. Mr. Sheldon David could not recall seeing the promotional materials for

MCDA II. When he acquired the interest in MCDA II, Mr. Sheldon David was not aware of the significant problems in developing the Terra-Drill technology. Nor could he specifically recall all of the proposed activities of the partnership. He was not aware of the Overthrust Belt where the proposed exploratory drilling was to be conducted by the partnership. Nor did he have any personal knowledge of the development drilling program. Mr. Sheldon David was unaware of the amount paid by MCDA II to acquire the Terra-Drill sublicense and could not recall the exclusive territory where the partnership proposed to market the technology under the sublicense. Mr. Herman David frankly admitted that he relied completely upon his children for investments. However, the record does not establish that Mr. Sheldon David or his accountant possessed the requisite expertise to provide advice in respect to the bona fides of the financial aspects of the transaction here at issue. Consequently, Mr. Herman David cannot avoid the additions to tax for negligence on the ground that in making this investment, he relied in good faith on professional advice. We must conclude on this record that petitioner David in this case was negligent and, therefore, liable for the additions to tax for negligence for the taxable year involved. We so hold.

The next issue is whether certain of the petitioners herein involved are subject to the addition to tax pursuant to section 6661. Respondent states on brief that section 6661 is at issue only in the cases involving petitioners Michael Sirkus, Lester H. Strickler, Eugene Pitts, and Herman David. With respect to returns filed after December 31, 1982, section 6661(a) imposes an addition to tax equal to 25 percent of any underpayment attributable to a substantial understatement of income tax. *Pallottini v. Commissioner*, 90 T.C. 498 (1988). An understatement of tax is substantial if it exceeds the greater of 10 percent of the amount required to be shown on the return for the taxable year or $5,000. Sec. 6661(b)(1). An understatement is the amount by

which the amount required to be shown on the return exceeds the amount actually shown on the return. Sec. 6661(b)(2). Each of the cases mentioned above meets this threshold requirement.

If a taxpayer has substantial authority for the tax treatment of an item on his return, the understatement is reduced by the amount attributable to such item. Sec. 6661(b)(2)(B)(i). Furthermore, if a taxpayer adequately discloses on his return the relevant facts pertaining to any tax item, the amount of the understatement is reduced by the amount of such item. Sec. 6661(b)(2)(B)(ii). However, if the tax item is attributable to a tax shelter, the amount of the understatement may only be reduced where there is substantial authority for the taxpayer's position and in addition the taxpayer reasonably believed his tax treatment of the item was more likely than not the proper tax treatment. Sec. 6661(b)(2)(C)(i). A tax shelter is defined as a partnership, entity, investment plan, or other plan or arrangement whose principal purpose is the avoidance or evasion of Federal income tax. Sec. 6661(b)(2)(C)(ii).

We believe that the partnerships in which the above-referenced petitioners acquired interests were clearly tax shelters as defined by the statute. We are satisfied that the principal purpose of the partnerships in question was the avoidance of Federal income tax. Our finding that the proposed programs of the partnerships were not profit-motivated and lacked economic substance reinforces this conclusion. We need not repeat our analysis above which underscored these findings. Since profit was not one of the partnerships' possible outcomes, which is evident from the complete absence of any economic feasibility in the proposed partnership activities and the sheer impossibility of generating income to meet the grossly inflated obligations of the entity, and where the promised tax benefits are substan-

tial, we find that partnerships' principal purpose was tax avoidance.

We do not believe that any of the above-referenced petitioners reasonably believed that the claimed tax treatment was "more likely than not" the proper treatment. Sec. 6661(b)(2)(C)(i). From the testimony of said petitioners it is abundantly clear that they did not make the kind of independent legal or factual analysis of the relevant partnership programs which would enable them to formulate any reasonable belief one way or another as to whether the tax treatment given to the claimed deduction was more likely than not the proper tax treatment. Indeed, the general approach of the petitioners to the economic aspects of their investments in their respective partnerships, as contrasted to the tax benefits involved, was one of studied indifference. See *Ferrell v. Commissioner*, 90 T.C. 1154, 1205-1206 (1988). We hold that the addition to tax under section 6661 is applicable with respect to the above-referenced petitioners in the taxable years involved.

The next issue we must decide is whether petitioners are liable for the increased rate of interest pursuant to section 6621(c). The increased rate of interest is 120 percent of the statutory rate for substantial underpayment (defined as underpayments of at least $1,000) attributable to tax motivated transactions. Sec. 6621(c)(1). Deductions disallowed for any period under section 183 relating to an activity not engaged in for profit are included as tax motivated transactions in the temporary regulations. Sec. 301.6621-2T, Q-4 and A-4, Temporary Proced. & Admin. Regs., 49 Fed. Reg. 50391 (Dec. 28, 1984). See *Patin v. Commissioner*, 88 T.C. 1086 (1987), affd. without opinion sub nom. *Hatheway v. Commissioner*, 856 F.2d 186 (4th Cir. 1988), affd. sub nom. *Skeen v. Commissioner*, 864 F.2d 93 (9th Cir. 1989), affd. without published opinion *Patin v. Commissioner*, 865 F.2d 1264 (5th Cir. 1989), affd. sub nom. *Gomberg v. Commis-*

sioner, 868 F.2d 865 (6th Cir. 1989). We have previously found that the activities engaged in by the partnerships were activities not engaged in for profit under section 183. Underpayments resulting from the disallowance of deductions under section 183 are, therefore, subject to section 6621(c). Accordingly, we hold that the increased rate of interest under section 6621(c) applies to the underpayments involved in these cases.

The next issue we must decide is whether petitioners are liable for damages pursuant to section 6673. Section 6673 authorizes this Court to award damages (now called a penalty) to the United States whenever it appears that a taxpayer instituted or maintained a proceeding before this Court primarily for delay, that the taxpayer's position in such proceeding is frivolous or groundless, or, with respect to proceedings commenced after October 22, 1986, that the taxpayer unreasonably failed to pursue available administrative remedies. Here the parties presented the reports and testimony of expert witnesses with respect to the economic feasibility of the activities of the six partnerships here involved and the parties presented testimony and evidence bearing upon the applicability of section 183 to the transactions at issue. Our resolution of the main issues before the Court turned upon the factual determination under section 183. The economic validity and the bona fides of both the Terra-Drill sublicensing activities and the oil and gas development drilling programs of the partnerships were at issue. The record is voluminous. We are reluctant to conclude that petitioners did not undertake to litigate the factual merits of these partnership programs in good faith. Consequently, and in the exercise of our discretion, we decline to require petitioners to pay a penalty under section 6673.

Decisions will be entered under Rule 155.

APPENDIX

No. 94-70888

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ROSCOE C. WEBB, JR.,
Petitioner-Appellant,

v.

COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Tax Ct. No. 11415-85

ORDER

FILED
January 5, 1996

CATHY A. CATTERSON, Clerk
U.S. COURT OF APPEALS

Before: HALL and RYMER, Circuit Judges, and FITZGERALD, District Judge.*

The panel has voted to deny appellant's petition for rehearing. Judges Hall and Rymer have voted to reject the suggestion for rehearing en banc and Judge Fitzgerald has recommended rejection.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

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* The Honorable James M. Fitzgerald, Senior United States District Judge for the District of Alaska, sitting by designation.